

June 12, 2017 06:47 AM GMT

FX Morning

Risk stays on. Ahead of [Wednesday's FOMC meeting](#), US financial conditions continue to improve, supported by the US House Republicans passing the vote to revamp the Dodd-Frank Act and repeal the Volcker Rule which restricted banks from making speculative investments with their own capital. This suggests freer investment in riskier assets as well as lower US funding costs. Hence, [we pay little attention](#) to the 1.8% decline of the NASDAQ on Friday, considering the resilience of the broader S&P 500 and limited spillover into Asian equity markets. A 25bp Fed Funds rate hike is 95% priced in, suggesting that all eyes will be on the statement in respect of the Fed's judgement of the future economic outlook, and on the FOMC providing updates on their Policy Normalization Principles and Plans, including a set of gradually increasing caps, or limits, on the dollar amounts of Treasury and agency securities that would be allowed to run off each month, and only the amounts of securities repayments that exceeded the caps would be reinvested each month.

Treasury Secretary Mnuchin said that the US government has "backup plans" for funding itself if Congress doesn't raise the debt limit before lawmakers leave for their August recess as hoped. When the US Treasury used accounting methods to bridge shortfalls ahead of the increase of the 2015 debt ceiling, US front-end rates fell to zero, but this happened within an environment of increasing global deflation concerns and China facing risks of substantial outflows threatening financial stability. Nowadays, global growth conditions are supportive as 2015 global economic headwinds have turned into powerful tailwinds for the US. The Treasury using accounting flexibility suggests it will issue less, which may ease US financial conditions further. There is no need for the Fed to reconsider the pace of its anticipated tightening path, it seems.

Moderation. According to [Reuters](#), German retailer Aldi has announced it will invest USD3.4bn into new US supermarket chains. Not so long ago markets were discussing US import tax changes and their bearish impact on (importing) retailers. Aldi's announcement suggests that these concerns may have eased. In addition, US President Trump's acknowledgment for the first time since taking office that the US stands ready to help if there was an military attack on any NATO member leaves the impression of a new pragmatism entering US policies.

USD Rebound. Thursday's FX Pulse titled '[Tactical USD Rebound](#)' argued that USD bearish sentiment expressed by positioning in the USD and, maybe more importantly, within the US yield curve has gone too far. Investors were too impressed by the evolution of economic surprise indicators, ignoring strong financial conditions, US hard data staying generally strong and Fed communication staying committed to monetary policy normalisation. Our [ARIA indicator](#) has rebounded sharply by 1.8%M, the largest in the history of the series, suggesting that US 2Q GDP tracking may drift higher over the course of the month. This week will also see meetings by the SNB, BoE and BoJ. None of these central banks operate within strong enough domestic environments to signal a move away from their current accommodative approaches. [The BoE](#) has to acknowledge the more unstable post General Election domestic political

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backdrop, the SNB has been challenged by a renewed weakening of its capital expenditure outlook and the BoJ has not seen a sufficiently strong inflation rebound to call victory over deflationary forces.

The USD's oil link. Oil has bounced from levels near its May lows, helped by easing global stockpiles and Saudi Arabia's Energy Minister Khalid Al-Falih predicting a further decline of oil inventory as global oil demand picks up. The USD has traded increasingly like an oil currency as its oil output reaches near USD9.5mn bpd and its oil rigs continue to rise. The number of drilling rigs in the US rose from the May low of 404 to 927 rigs last week, according to Baker Hughes. Higher oil prices, combined with a Fed statement underpinning its current rate expectations, should help USDJPY in particular.

Buy GBP for now. The [outcome of the UK's General election](#) is likely to change UK Brexit policies as indicated by the promotion of the pro-EU Damian Green to First Secretary of State, effectively becoming Theresa May's deputy PM. The DUP has made it clear that it wants to keep the border between the Republic and Northern Ireland open, suggesting a softer form of Brexit. The 'No Deal is Better than a Bad Deal' option no longer has a political majority in the UK. Brexit-related law changes will find it difficult to find a majority in the Commons. The Tory Party's moderate forces have gained power with, for example, Ruth Davidson, the Scottish Tory leader, arguing for an 'Open Brexit'. GBP trades on Brexit economics, suggesting GBPUSD will rebound to 1.32 for now. Long-term GBP bear market dynamics may, however, stay intact.

Trades of the week

- Buy GBP/JPY at market with a target of 148 and stop at 139
- Buy USD/ZAR at market with a target of 13.70 and a stop at 12.60

Click through for our [Trade Ideas of the Week](#) and [Week Ahead Calendar](#)

Exhibit 1: The USD trades increasingly like an oil currency



Source: Bloomberg, Macrobond, Morgan Stanley Research

Trade Ideas of the Week

G10 - Buy GBP/JPY

We view the GBP setback as a tactical buying opportunity against JPY. The markets have priced in more political uncertainty after the hung Parliament election results, giving potential for a relief rally in GBP once it is confirmed that the Conservative Party will stay in government with support from the DUP. At the moment, this looks likely with the DUP suggesting ["the talks \(with the Conservatives\) so far have been positive"](#). The appointment of Remain supporter Damian Green as First Secretary of State and the DUP making it clear that it wants to keep the border between the Republic and Northern Ireland open suggest a softer form of Brexit. The election results also suggest a looser fiscal policy and reduced likelihood of a second Scottish referendum as signaled by the SNP's Sturgeon, which are GBP-positive factors. Funding a looser fiscal policy with debt will steepen the UK yield curve and could spill over to other countries' curves. Steeper curves globally, coupled with potential for a tactical rebound in US yields should the Fed revise their 2018 dots up this week as [our economists expect](#), should weaken the JPY most, based on currencies' sensitivity to US yields and curve steepness. BoJ's Kuroda is likely to reiterate his dovish stance in the BoJ meeting this week, quashing market speculation of the BoJ moving towards policy tightening. The risk to this trade is if talks between the Conservatives and DUP fail, allowing political uncertainty to stay heightened.

We like to buy GBP/JPY at market with a target of 148 and stop at 139.

EM - Buy USD/ZAR

We recommend going long USDZAR for the week ahead. We initiated this trade in the FX Pulse portfolio last Thursday, and with Moody's announcing a downgrade of South Africa's credit rating on Friday, and leaving the outlook at negative, we believe the momentum will remain toward a weaker ZAR. South Africa is back in recession, with Q1 GDP surprising significantly to the downside at -0.7% q/q, with our economists suggesting the economy could barely grow at all this year, see [CEEMEA Compass: Constructive, but Qatar Casts a Shadow, 9 June 2017](#). While the rebalancing of the current account deficit will likely remain supportive of the currency, given the fact that it is coming on the back of weak growth with little prospect of economic policy changes to lift business confidence we are not convinced it will be enough to prevent the currency from depreciating. We see the currency underperforming peers, but with the USD expected to rebound in the short term we recommend going long USDZAR. A risk to this trade would be continued risk appetite fuelling complacency over key political and economic risks present in South Africa.

We like to buy USDZAR at market with a target of 13.70 and a stop at 12.60.

Week Ahead Calendar

Click on an event below to see our economists' analysis or [click here](#) for an interactive, searchable calendar.

Exhibit 2: Week Ahead Calendar

Date	Time (Ldn)	Ccy	Event	Ref. Period	MS forecast	Market	Previous
12-18 J	N/A	CNY	Foreign Direct Investment (YoY, CNY)	May			-4.3%
12-15 J	N/A	CNY	M2 (YoY)	May	10.5%	10.4%	10.5%
12-15 J	N/A	CNY	New Yuan Loans	May	1050B	1000B	1100B
12-15 J	N/A	CNY	Aggregate Financing RMB	May	1150B	1190B	1394B
12-Jun	08:00	TRY	GDP (YoY)	1Q	4.2%	3.5%	3.51%
12-Jun	09:00	CHF	SNB Sight Deposits				576.1B
12-Jun	09:00	EUR	Italian Industrial Production (MoM)	Apr	-0.7%	0.2%	0.4%
12-Jun	09:30	AUD	RBA's Debelle spks (Global FX Code of Conduct Launch)				
12-Jun	13:00	PLN	CPI (YoY)	May F	1.9%		1.9%
12-Jun	13:00	INR	CPI (YoY)	May	2.6%	2.38%	2.99%
12-Jun	17:50	CAD	BoC's Wilkins Speech Text Published (Asper School of Business)				
13-Jun	02:30	AUD	NAB Business Confidence	May			12.9
13-Jun	N/A	GBP	PM May, DUP's Foster Meet				
13-Jun	08:00	EUR	Spanish CPI (YoY)	May F		1.9%	1.9%
13-Jun	08:00	SEK	Riksbank's Ingves spks (Hearing on Financial Stability)				
13-Jun	08:10	EUR	ECB's Weidmann spks (G20 Africa Partnership Conf)				
13-Jun	08:30	SEK	CPI (YoY)	May		1.6%	1.87%
13-Jun	08:30	SEK	CPI CPIX (YoY)	May		1.7%	2%
13-Jun	09:00	NOK	Regional Network Survey output 6m out	May			1.02
13-Jun	09:30	GBP	CPIH (YoY)	May		2.6%	2.6%
13-Jun	09:30	GBP	CPI (YoY)	May	2.7%	2.7%	2.7%
13-Jun	10:00	EUR	German ZEW Survey Current Situation	Jun	86.0	85	83.9
13-Jun	10:00	EUR	German ZEW Survey Expectations	Jun	20.5	21.7	20.6
13-Jun	10:00	EUR	Eurozone ZEW Survey Expectations	Jun			35.1
13-Jun	10:00	EUR	ECB's Lautenschlager spks (Regulation)				
13-Jun	11:00	USD	NFIB Small Business Optimism	May		104.5	104.5
13-Jun	11:30	EUR	Estonia's Orlova spks (Trade Priorities of EU Presidency)				
13-Jun	13:00	PLN	CPI Core (YoY)	May	1.00%	1%	0.9%
13-Jun	13:30	USD	PPI (YoY)	May	2.1%	2.3%	2.5%
13-Jun	23:45	NZD	Food Prices (MoM)	May			-0.8%
13-Jun	23:45	NZD	Current Account Balance	1Q		1B	-2.335B
14-Jun	00:30	AUD	Consumer Confidence				112.9
14-Jun	03:00	CNY	Retail Sales (YoY)	May	10.7%	10.7%	10.7%
14-Jun	03:00	CNY	Fixed Assets Ex Rural YTD (YoY)	May	8.8%	8.8%	8.9%
14-Jun	03:00	CNY	Industrial Production (YoY)	May	6.4%	6.4%	6.5%
14-Jun	05:30	JPY	Industrial Production (MoM)	Apr F			4%
14-Jun	07:00	SEK	TNS Sifo Prospera Inflation Expectations Survey				

14-Jun	07:00	EUR	German CPI (YoY)	May F	1.5%	1.5%	1.5%
14-Jun	07:30	INR	Wholesale Prices (YoY)	May	3.1%	2.9%	3.85%
14-Jun	08:30	SEK	Riksbank Business Survey	May			
14-Jun	09:00	EUR	ECB's Knot spks (Dutch Parliament)				
14-Jun	09:00	EUR	ECB's Hansson spks (Economic Outlook)				
14-Jun	09:00	EUR	ECB's Weidmann spks (Frontiers in Central Banking)				
14-Jun	09:30	GBP	Jobless Claims Change	May			19.4k
14-Jun	09:30	GBP	Average Weekly Earnings (3M/Y) (incl. bonuses)	Apr	2.5%	2.4%	2.4%
14-Jun	09:30	GBP	Average weekly wages (ex bonuses) (3m Av, YoY)	Apr	2.0%	2%	2.1%
14-Jun	09:30	GBP	ILO Unemployment Rate 3Mths	Apr	4.5%	4.6%	4.6%
14-Jun	09:30	GBP	Employment Change 3M/3M	Apr	136k	125k	122k
14-Jun	10:00	EUR	Industrial Production (MoM)	Apr	0.2%	0.5%	-0.1%
14-Jun	13:30	USD	CPI (YoY)	May	2.0%	2%	2.2%
14-Jun	13:30	USD	CPI Ex Food and Energy (YoY)	May	1.9%	1.9%	1.9%
14-Jun	13:30	USD	Retail Sales Advance (MoM)	May	-0.3%	0.1%	0.4%
14-Jun	13:30	USD	Retail Sales Ex Auto (MoM)	May	-0.1%	0.1%	0.3%
14-Jun	13:30	USD	Retail Sales Control Group (MoM)	May	0.1%	0.3%	0.2%
14-Jun	14:30	SEK	Riksbank's Skingsley spks (New Technologies Central Banking)				
14-Jun	15:00	USD	Business Inventories	Apr		-0.1%	0.2%
14-Jun	15:30	USD	EIA Crude Oil Inventories				3295k
14-Jun	18:30	EUR	ECB's Rimsevis spks				
14-Jun	19:00	USD	FOMC Rate Decision (Upper Bound)		1.25%	1.25%	1%
14-Jun	19:00	USD	FOMC Rate Decision (Lower Bound)		1.00%	1%	0.75%
14-Jun	19:00	USD	Fed Summary of Economic Projections				
14-Jun	19:30	USD	FOMC Press Conference				
14-Jun	23:45	NZD	GDP (QoQ)	1Q		0.7%	0.4%
14-16 J	N/A	INR	Trade Balance	May	-\$13.9B	-\$12.44B	-\$13.2B
14-16 J	N/A	INR	Exports (YoY)	May			19.77%
15-Jun	N/A	IDR	BI Rates Decision		4.75%	4.75%	4.75%
15-Jun	00:50	JPY	Japan MoF Weekly Security Flow				
15-Jun	02:30	AUD	Employment Change	May	0k	10k	37.4k
15-Jun	02:30	AUD	Unemployment Rate	May	5.8%	5.7%	5.7%
15-Jun	07:45	EUR	French CPI (YoY)	May F	0.8%	0.8%	0.8%
15-Jun	08:30	CHF	SNB Rates Decision			-0.75%	-0.75%
15-Jun	08:40	AUD	RBA's Debelle spks (Thomson Reuters Event)				
15-Jun	09:00	EUR	Italian CPI (YoY)	May F	1.4%	1.5%	1.5%
15-Jun	09:30	GBP	Retail Sales (MoM)	May	-0.7%	-1%	2%
15-Jun	10:00	EUR	Trade Balance	Apr	20.1B	22b	23.07b
15-Jun	12:00	GBP	BoE Rates Decision		0.25%	0.25%	0.25%
15-Jun	12:00	TRY	CBT Rates Decision		8.00%	8%	8%
15-Jun	13:30	CAD	Manufacturing Sales (MoM)	Apr		1%	1.03%
15-Jun	13:30	USD	Empire Manufacturing	Jun		5	-1
15-Jun	13:30	USD	Initial Jobless Claims		237k	241k	245k
15-Jun	13:30	USD	Philadelphia Fed Business Outlook	Jun		25	38.8
15-Jun	14:00	EUR	Eurogroup Meeting				
15-Jun	14:00	CAD	Existing Home Sales (MoM)	May			-1.7%
15-Jun	14:15	USD	Industrial Production (MoM)	May	0.3%	0.2%	0.98%
15-Jun	14:15	USD	Capacity Utilization	May	76.9%	76.8%	76.7%

15-Jun	14:15	USD	Manufacturing Production (MoM)	May		0.1%	1%
15-Jun	15:00	USD	NAHB Housing Market Index	Jun		70	70
15-Jun	16:30	ILS	CPI (YoY)	May	0.7%	0.7%	0.71%
15-Jun	21:00	GBP	BoE's Carney spks (Mansion House)				
15-Jun	21:00	USD	Total Net TIC Flows	Apr			-0.7B
15-Jun	22:00	KRW	Export Price Index (YoY)	May			8.7%
15-Jun	23:00	CLP	CBCH Rates Decision		2.50%	2.5%	2.5%
15-Jun	23:30	NZD	Manufacturing PMI	May			56.8
16-Jun	N/A	JPY	BoJ Rates Decision		-0.10%	-0.1%	-0.1%
16-Jun	N/A	JPY	BoJ 10y Yield Target		0.00%	0%	0%
16-Jun	01:30	SGD	Non-oil Domestic Exports (YoY)	May		-5.6%	-0.7%
16-Jun	07:00	NOK	Trade Balance	May			22.25B
16-Jun	07:30	JPY	BoJ Press Conference				
16-Jun	07:45	EUR	French Wages (QoQ)	1Q F		0.6%	0.6%
16-Jun	09:00	EUR	ECOFIN Meeting				
16-Jun	09:00	EUR	Italian Trade Balance	Apr			5418m
16-Jun	10:00	EUR	CPI (YoY)	May F	1.4%	1.4%	1.4%
16-Jun	10:00	EUR	CPI Core (YoY)	May F	0.9%	0.9%	0.9%
16-Jun	11:30	RUB	CBR Rates Decision		8.75%	9%	9.25%
16-Jun	13:30	USD	Housing Starts	May	1215k	1218k	1172k
16-Jun	13:30	USD	Housing Starts (MoM)	May	3.7%	3.9%	-2.6%
16-Jun	15:00	USD	Labor Market Conditions Index	May			3.5%
16-Jun	15:00	USD	Univ. of Michigan Confidence	Jun P		97.1	97.1
16-Jun	17:45	USD	Fed's Kaplan (voter) spks (Park Cities Rotary Club)				
16-Jun	N/A	GBP	UK Sovereign Debt Rating (DBRS)				
16-19 J	N/A	RUB	GDP (YoY)	1Q P	0.5%	0.5%	0.5%
16-20 J	N/A	JPY	Nationwide Dept Sales YoY	May			0.7%
18-Jun	11:00	ILS	GDP (QoQ)	1Q P	2.1%	1.7%	1.4%
18-Jun	23:30	NZD	Performance Services Index	May			52.8
18-23 J	N/A	NZD	Westpac Consumer Confidence Index	2Q			111.9

Source: Bloomberg, Morgan Stanley Research

Appendix

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

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(as of May 31, 2017)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
Overweight/Buy	1146	35%	298	41%	26%	560	37%
Equal-weight/Hold	1411	44%	333	46%	24%	679	45%
Not-Rated/Hold	59	2%	8	1%	14%	8	1%
Underweight/Sell	616	19%	87	12%	14%	262	17%
TOTAL	3,232		726			1509	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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