3 May 2022

FX Strategy

Tighter liquidity everywhere – except for Japan

- **Most G10 central banks to initiate quantitative tightening to complement hikes.**
- **Markets are pricing more expensive USD liquidity in the basis curve, but it has further to go in our view.**
- **This adds to carry on short EUR/USD and long USD/JPY positions.**

Centre of attention in the global monetary tightening cycle so far has been interest rate increases. The Riksbank hiked for the first time last week, the Reserve Bank of Australia hiked today, and we expect more central banks to start hiking in the coming months – most notably the ECB in July. Most G10 central banks with quantitative easing (QE) are in the process of decreasing balance sheets. We expect the Fed to announce a start of quantitative tightening (QT) tomorrow, which could put the spotlight on the wind down of central bank balance sheets. The table below provides an overview of the outlook for G10 central banks' QE/QT policies.

All G10 central banks (with the exemption of Bank of Japan (BoJ)) have started a process of tightening liquidity conditions. Some are still (partly) reinvesting maturing bond holdings, while others look to start selling off bonds. While this should mostly complement rate hikes by balancing supply and demand for central bank liquidity, the parallel QT will likely add to tighter global financial conditions.

The Fed is the most important in our view when it comes to central bank liquidity because of the importance of USD liquidity for global financial markets and the economy. Tighter USD liquidity conditions are coming. The ECB is likely to start tightening EUR liquidity conditions, but we doubt it will be as materiel as the Fed. The EUR/USD RFR basis curve prices more expensive USD liquidity, but it has further to go in our view. The 1Y tenor could widen a further 20-30bp, which would further add to carry on short EUR/USD positions. From a carry perspective, it supports our still bearish view on EUR/USD spot.

As mentioned above, the BoJ is a different story. The BoJ affirmed its easing stance last week, which commits it to QE to cap JGB yields. The upwards pressure on JGB yields from higher global yields following tightening everywhere else actually reinforces BoJ's easing stance. The liquidity divergence will likely apply widening pressure on USD/JPY OIS basis. The rally in USD/JPY spot has come a long way in part due to this factor.

Overview of outlook for G10 central bank balance sheet policies

BoJ	To keep the 25bp ceiling on the 10-year yield the BoJ will continue to conduct unlimited buying operations of Japanese government bonds.
ECB	Net purchases ending. Reinvestments to continue at least until end 2023. TLTRO will gradually be repaid. Hence tighter euro liquidity.
Riksbank	QE reinvestments are announced to SEK37bn for H2, which is a cut from SEK37bn in Q2. I.e. starting a QT process
Fed	We expect the Fed to announce the balance sheet runoff to start in mid-May. We expect the cap to be set at USD95bn as outlined in the minutes. With a great deal of uncertainty, we expect Fed to hit a lower threshold for reserve demand from banks in early 2024.
RBA	RBA will not reinvest maturing bond from the QE program, which ended in February. So far refrains from selling bond holdings.
BoC	BoC will no longer replace maturing Government of Canada bonds on the BoC's balance sheet and, as a result, the size of the balance sheet will decline over time.
BoE	BoE announced QT and communicated that active QT will begin once the bank rate reaches 1% (which is expected at May meeting)
RBNZ	RBNZ to sell off bond holdings from July

Note: Norges Bank (NB), Swiss National Bank (SNB) and Danmarks Nationalbank (DN) are excluded due to the absence of QE programmes

Source: Central bank statements and Danske Bank expectations, BOJ, ECB, Riksbank, Fed and BoE are Danske Bank expectations; rest is official central bank statements

Our view on key themes & trades in FX

1. The dollar going higher.
2. Peak manufacturing cycle, via China.
3. Tightening liquidity.
4. Brent range USD100-130.

General market beliefs:

- EUR/USD around 1.05.
- Peak Scandies vs. USD.
- Neutral on Scandies vs. EUR.
- Peak EM vs. USD, incl. Asia.

Source: Danske Bank

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Table 1. Danske FX Trading Portfolio - Open Trades 2022

Trade	Opened	Entry	Closed	Current	PnL
Buy 6M EUR/USD put spread	02/12/21	1.1342		1.0501	3.4%
Short GBP/USD spot	02/12/21	1.33		1.25	5.9%
Long EUR/DKK 12M forward	02/12/21	7.43		7.44	0.0%
Long 6M 8.5600-8.8600-9.1600 USD/NOK seagull	11/02/22	8.84		9.46	2.4%

Source: Danske Bank

Table 2. Danske FX Trading Portfolio - Closed trades in 2022

Trade	Opened	Entry	Closed	Close level	PnL
Short EUR/CZK spot	18/05/21	25.4240	06/01/22	24.6150	4.2%
Short EUR/JPY spot	02/12/21	127.98	04/02/22	132.00	-3.0%
Short PLN/CZK spot	02/12/21	5.53	09/02/22	5.40	2.5%
Long NZD/SEK spot	02/12/21	6.17	10/02/22	6.20	0.7%
Long USD/ZAR spot	02/12/21	15.85	17/02/22	14.95	-6.9%
Short EUR/CHF spot	02/12/21	1.0421	22/02/22	1.0400	0.2%
Short NOK spot vs USD and EUR (equal weighted)	02/12/21	100.00	28/02/22	97.13	-2.9%

Source: Danske Bank

Recent FX strategy

2022

- FX Strategy - Regime shift in Asia bodes well for broad USD strength (26. April)
- FX Strategy - ECB fighting gravity in "reverse currency war" (22. April)
- FX Strategy - Time for new lows in EUR/USD (5. April)
- FX Strategy - A vicious inflation cycle in the makings? (29. March)
- FX Strategy - Sterling: stability versus EUR - but towards 1.25 vs USD (22. March)
- FX Strategy - Fed hikes, but re-pricing of EUR/USD FX swaps not done (21. March)
- FX Strategy - Global manufacturing to stagnate in coming months (15. March)
- FX Strategy - EUR/USD can drop to 1.05 in a worst case of Brent at 150 (8. March)
- FX Strategy - Oil diplomacy (1. March)
- FX Strategy - EUR/USD victim of political choices (22. February)
- FX Strategy: ECB was a one-off shock - EUR/USD to decline again (8. February)
- FX Strategy: 'Not hawkish enough' - EM benefit from commodities rally (1. February)
- FX Strategy - Didn't commodities get the message? (25. January)
- FX Strategy - Lower EUR/USD on valuation, EU disappointment and CBs (18. January)
- FX Strategy - Fed pivoting hawkish - though FX effects are not via yields (11. January)
- FX Strategy - EUR/CHF to continue setting new lows in 2022 (4. January 2022)

2021

- FX Strategy - Policy tightening bad news for leverage - good for USD (14. December)
- FX Top Trades 2022 - Our guide on how to position for the year ahead (3. December)
- FX Strategy: EUR/USD sees temporary boost from falling commodities (30. November)
- FX Strategy - US inflation surprise aligns incentives to strengthen dollar (16. November)
- FX Strategy - Which CB is next to credibly hike rates 100bp (8. November)
- FX Strategy - Rising rates & equities drive EUR lower against all (2. November)
- FX Strategy - Flows & fundamentals are a drag on EUR/USD (26. October)
- FX Strategy - Time to cut global growth forecasts (19. October)
- FX Strategy - Debt ceiling solution to push EUR/USD FX forwards higher (13. October)
- FX Strategy - The return of EUR as a funding currency (12. October)
- Strategy - Stagflation rhymes with peak performance for Europe (4. October)
- FX Strategy - Back to the 80's? Dollar upside risks on the rise (28. September)
- FX Strategy - An open dollar position continues to add alpha (20. September)
- FX Strategy - EU's Maastricht criteria may well become a topic in 2022 (14. September)
- FX Strategy - Temporary bounce in EUR/USD justified by ambiguous data (7. September)
- FX Strategy - Short EUR/JPY: PMIs fading while Japan catch up (30. August)
- FX Strategy - Downside risk to EUR/USD spot (23 August)
- FX Strategy - SRF enables steeper Fed hiking path (3. August)
- FX Strategy - Evidence of 'twin peak' are adding up to dollar strength (5. July)
- FX Strategy - No OPEC+ drama this week - Fed signals more important (29. June)
- FX Strategy - Snap reversal of reflation has taken EUR/USD lower (21. June)
- FX Strategy - Fed to shift a bit more hawkish (15. June)
- FX Strategy - Interventionism remains an important long-term FX factor (8. June)
- FX Strategy - Summer lull hits DM FX (31. May)
- FX Strategy - Strong manufacturing keeping dollar on weak footing (25 May)
- FX Strategy - Goods prices are driving hawks in Eastern Europe (18. May)
- FX Strategy - Dollar: Peak reflation, bottlenecks or debasement? (11. May)
- FX Strategy - Short USD - but mind the risk of gaps (3. May)
- FX Strategy - Time to prepare for monetary divergence (26. April)
- FX Strategy - Reflation back in vogue (19. April)
- FX Strategy - Rising US inflation puts the dollar at a crossroad (12. April)
- FX Strategy - US shines - bad news for NOK and EM (7. April)
- FX Strategy - Where to next? Three trades we are looking at for H2 (30 March)
- FX Strategy - Lira is yet another casualty of the cross-asset turning point (23 March)
- FX Strategy - EUR/CHF: Pick a view on rates, then trade it (16 March)
- FX Strategy - Short AUD/USD as commodity momentum could taper off (8. March)
- FX Strategy - Momentum strikes back... and it will continue (3. March)
- FX Strategy - Pick a side: Commodity supercycle or US real rates (23 February 2021)

Source: Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Allan von Mehren, Chief Analyst.

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