3 December 2020

FX Top Trades 2021

Our guide on how to position for the year ahead

It is that time of year again… and we present our FX Top Trades for 2021. As a foundation for all trades, we present five themes, which we think will set the agenda for the FX market in the year to come (Table 1). These themes in turn serve to motivate the individual trades we adopt. We include both spot/forward and option strategies with the latter allowing us to express longer-term views if/when e.g. short-term risks may be in the opposite direction.

While the macro outlook is still fragile in Europe and the US over the winter due to a high number of COVID-19 cases and restrictions, we think the global macro outlook for 2021 is brighter, as the vaccination process is set to start, probably in the second half of this month. We expect restrictions to be eased in spring aided by the seasonal weather and a vaccine means that restrictions will not need to be re-imposed next autumn. The Chinese economy has recovered strongly from the COVID-19 crisis, as stimulus, catch-up from lost production and a lift to exports boosted demand. We project growth will shift down a gear in 2021 towards cruising speed and that China will thus be less of a global growth booster in 2021. For more details see *The Big Picture: Darkest before dawn*, 1 December.

In an FX context, we find it essential to distinguish strategic and tactical trends based on the general investment environment, see (*Theme #1*). Strategic drifts are inherently more long term in nature and often driven by risk-adjusted real interest rates, unit labour costs and/or terms of trade, as well as net international investment positions. Meanwhile, a range of more FX-relevant cycles are worth considering. Oil prices are not yet in for a structural slump even if the focus on renewables increases ((*Theme #2)*. The USD cycle has yet to turn (*Theme #3*). The USD money-market lull may come to an end in 2021 as the demand for USD liquidity remains even if crisis measures run off (*Theme #4*). Finally, the Chinese cycle may peak in H1 as the structural need for deleveraging manifests itself yet again (*Theme #5*). We distinguish between tactical Q1 2021 views (e.g. bullish NOK and GBP) and more structural 3M+ views to play out later in 2021 (e.g. EUR/USD, USD/SEK and EUR/HUF). Further, our baseline scenario aside, we stress that a key wildcard is whether global reflation will finally arrive next year - Happy FX trading 2021!

All the trades presented below – both spot and option ones – are included in the Danske FX Trading Portfolio. We will provide regular P/L updates on these. Entry prices are as always based on 14.00 CET Bloomberg fixings the day before (on 2 December 2020).

The FX Top Trades 2021 matrix: trades X themes

Trade x Theme	Expected horizon	#1 Strategic trends	#2 Road to oil market recovery	#3 USD cycle	#4 USD money market lull to end	#5 Peak in China cycle
#1: Short EUR/NOK	3M	☑	☑	☐	☐	☐
#2: Short EUR/USD	6M	☑	☐	☑	☑	☑
#3: Long USD/SEK	6M	☑	☐	☑	☑	☑
#4: Short EUR/GBP	3M	☑	☐	☐	☐	☐
#5: Short CAD/NOK	3M	☑	☑	☐	☐	☐
#6: Long EUR/HUF	6M+	☑	☐	☑	☐	☐
#7: Long EUR, JPY basket	6M+	☑	☑	☐	☐	☑
#8: Long RUB basket	6M+	☑	☑	☑	☐	☐

Source: Danske Bank

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Looking back at our 2020 top trades

Our FX top trades 2020 yielded a positive accumulated return of 9.7% (equal weight).

The hit ratio was 5 out of 7; one trade had zero and one had negative PnL.

Our two top positions yielded 5.5% and 2.3% in profits, respectively.

Last year's edition of *FX Top Trades 2020,* 5 December 2020, was set up as seven trades (see table 1) based on six themes. The themes were (i) mind the USD cycle, (ii) pick up carry in 'Blue', (iii) competitiveness lost!, (iv) inflation targets missed, (v) Scandi divergence tbc and (vi) political noise revisited. When evaluating the different trades, it is important to keep in mind the shock that came when COVID-19 closed down almost the entire global economy, causing financial stress to hit decade highs. Since March this has clearly dominated the more fundamental drivers of FX markets such as competitiveness and inflation. By extension our expectations for a modest global recovery during 2020, an intact USD-cycle and continued dollar-carry domination proved wrong.

Meanwhile, we managed to book profit on most trades ahead of the COVID-19 escalation in March (table 1). For instance, our tactical view that the NOK was set to get support from a range of metrics versus SEK and CAD proved right in late-2019 and January 2020, when risky assets overall performed strongly. On rising global risks in late January, we closed our short CAD/NOK spot position with a profit of 1.2% and a week later our revised NOK/SEK stop-profit was hit yielding +1.5% (chart 3). Also, our tactical view of a lower USD/CNH on cyclical and US-China trade-deal tailwinds to CNH proved right and we closed our short USD/CNH 6M forward outright position in late January on rising Chinese COVID-19. This trade yielded a 2.0% profit. In late-2019, we saw risks of the coming trade deal negotiations between UK and the EU as under-priced, making us position for a medium-term upswing in EUR/GBP via options. When Brexit risks re-emerged and EUR/GBP also went to the sky on COVID-19, we managed to book a 2.3% profit in May.

Our best-performing trade was our long EUR/HUF spot (chart 4). Although the reasons to put this trade on were strategic in nature, as HUF is suffering from both competitiveness and inflationary headwinds, this position also proved to be a hedge against the violent sell-off in risky assets during March as it pulled HUF down the drain. We booked a profit of whole 5.5% in mid-March, as the near-term outlook for further deterioration was limited.

The violent sell-off in the greenback in late February and early March on rising US COVID-19 fears wiped out our long USD-basket versus JPY, CHF and SEK and we were stopped out on 9 March with a PnL of -2.9%. Later in March, USD cash-flight made USD near decade highs. Deteriorating risk appetite also removed the foundation for our long EUR/JPY position played via options, which we closed down with zero PnL in mid-March.

Table 1: Danske Bank's FX Top Trades 2020 (sorted by time of closure)

Trade	Opened	Entry	Closed	Close level	PnL
Short USD/CNH 6M forward	04/12/19	7.0888	23/01/20	6.9443	2.0%
Short CAD/NOK spot	04/12/19	6.9169	23/01/20	6.8350	1.2%
Long NOK/SEK spot	04/12/19	1.0371	30/01/20	1.0490	1.5%
Long USD basket vs equal weighted SEK, CHF and JPY	04/12/19	100.0000	09/03/20	96.5000	-2.9%
Long 6M 120.4-126.0 ATMS EUR/JPY call spread	04/12/19	120.4000	16/03/20	118.6200	0.0%
Long EUR/HUF spot	04/12/19	330.9000	18/03/20	349.3000	5.5%
Short a 6M 0.8400-0.8800 ITM EUR/GBP put spread	04/12/19	0.8461	18/05/20	0.8919	2.3%

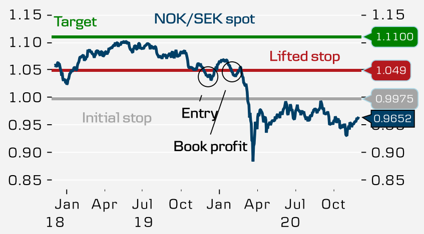
Past performance is not a reliable indicator of current or future results. Source: Bloomberg, Danske Bank

Table 2: Danske Bank FX top trades – PnL history since inauguration

Year	Hit Ratio	Avg. Return	Acc. Return	Best Trade	Worst Trade
2010	80%	3.7%	37.0%	10.5%	-4.6%
2011	80%	3.5%	35.0%	11.0%	-1.8%
2012	80%	2.1%	21.0%	7.1%	-2.2%
2013	60%	1.9%	19.0%	11.5%	-2.9%
2014	60%	0.8%	8.0%	6.9%	-2.9%
2015*	50%	-6.1%	-24.4%	4.3%	-19.2%
2016	75%	0.2%	1.1%	5.5%	-5.1%
2017	67%	0.7%	5.8%	3.9%	-6.8%
2018	57%	1.3%	9.1%	7.6%	-2.5%
2019	71%	1.1%	7.4%	3.2%	-1.8%
2020	71%	1.4%	9.7%	5.5%	-2.9%
Avg.**	68%	1.4%	11.7%	7.0%	-4.8%

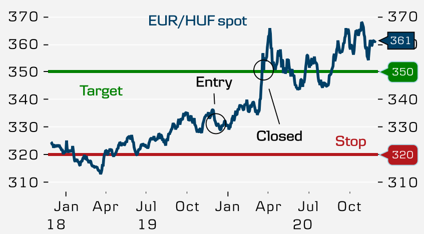
** SNB EUR/CHF floor removal*
*** Weighted by number of trades*
Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Danske Bank

Chart 3: Long NOK/SEK performed well in December 2019 and early-mid January - we got a 1.5% closing profit. Note how the magnitude of the moves in March dwarves most other movements



Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 4: Long EUR/HUF proved a decent hedge on the risk sell-off in March and we booked a 5.5% profit



Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Five FX themes

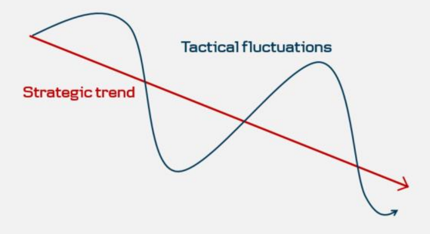
Theme # 1. Strategic trends

- **We highlight the importance of distinguishing strategic from tactical trends.**
- **Strategic drivers favour CHF, JPY, AUD and disfavour TRY, HUF, CZK.**
- **Direction of yields and equities crucial for NIIP-hedging flows.**

Betting with or against a strategic trend?

In *Cross Asset Research: A primer for consistent and systematic market analysis*, 21 June, we introduced a framework for consistent and systematic analysis of markets across asset classes including FX. In particular, we emphasised the importance of distinguishing between strategic and tactical trades. Before entering a trade, to us a key point is to realise whether one is betting *with* or *against* a strategic trend as this has significant implications for the expected return distribution and by extension the desired time horizon. Hence for a FX Top Trades 2021 publication it seems like a relevant starting point to (1) identify what drives strategic FX trends and (2) what it means for the currency outlook for 2021.

Chart 1.1: Betting with or against the strategic trend is key to identify



Note: Past performance is not a reliable indicator of current or future results. Note that it is not possible to invest directly in an index.
Source: Macrobond Financial, Danske Bank

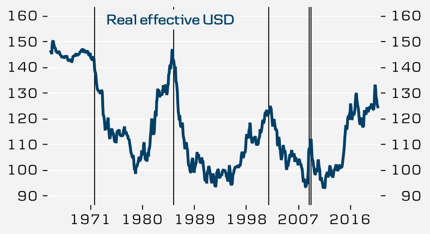
Identifying medium- and long-term drivers of FX markets

For FX markets we think the following three things are crucial for setting strategic trends.

Risk adjusted real rate parity. This is the combination of the purchasing power parity (PPP) combined with the uncovered interest rate parity (UIP), i.e. over time the risk premium adjusted real return should be the same across currencies. A rise in inflation and/or the risk premium of investing in a currency is negative for the spot value unless the nominal yield more than compensates.

Relative unit labour costs and terms of trades. Followers of FX markets know that the real rate parity only holds over longer time horizons and the real effective exchange rates may trend. Essentially this is due to the Balassa Samuelson effect as differences in productivity between the tradeable and non-tradeable sector play in. This is often related to terms of trade shocks, e.g. a positive term of trade shock to a commodity-exporting country results in productivity growth in the tradeable sector, yielding upward pressure on the exchange rate. Meanwhile, if cost pressures feed through to the service sector (which does not experience any productivity growth), this may hurt competitiveness. In other words, the profit impulse adjusted for productivity growth is highly important.

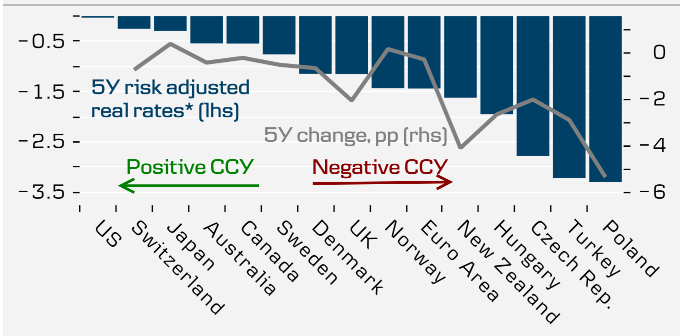
Chart 1.2: Strategic FX trends can be very persistent and self-enforcing



Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

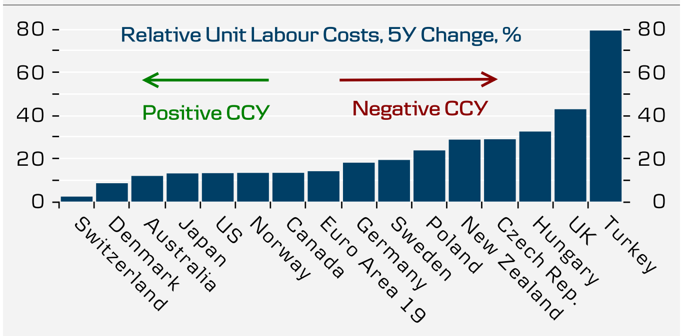
Net International Investment Positions (NIIP). This has in our view increasingly become a key driver of FX markets as changes to global asset values – both equity and debt – alongside carry differentials influence the rebalancing of FX hedges, e.g. when US equities rise foreign pension funds may mechanically sell more USD to maintain an unchanged hedge ratio. The same goes for debt portfolio assets where hedge ratios tend to be higher.

Chart 1.3: Risk adjusted real rates and 5Y absolute change



** 5Y Government bonds adjusted for realised inflation and 5Y CDS*
Source: Macrobond Financial, Danske Bank

Chart 1.4: 5Y change to unit labour costs



Source: Macrobond Financial, Danske Bank

The stickiness of trends and the implications for 2021

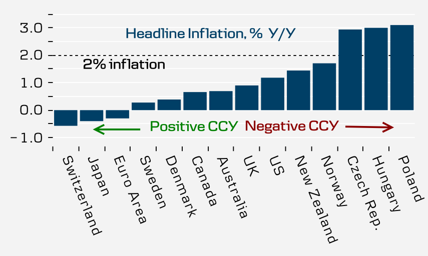
To us, it is really important to identify the strategic impact of these factors on any given exchange rate as the three are heavily interlinked via structural characteristics. What is more, the factors typically reinforce each other over time amplifying their persistency. The best examples of that are economies that have experienced pronounced declines in neutral rates such as Japan, Switzerland and the Eurozone as a consequence of amongst other things demographics and low productivity growth, see more in *Research Global: Euro area rates to stay very low for very long*, 13 June 2019. This has challenged central banks of such economies to use alternative methods to ease monetary conditions amid a post Great Financial Crisis-focus on fiscal austerity. However, some (rather most) of these central banks have failed to achieve their inflation targets (chart 1.5). Consequently, inflation has run too low. More problematically, inflation expectations have also become anchored at depressed levels and real rates have run at too elevated levels (relative to neutral rates) to achieve the inflation targets. Elevated real rates have weighed on domestic demand leading to large C/A surpluses as the economy has saved more than it has spent. Over time this has accumulated into large positive net debt NIIPs, which mechanically drive domestic-currency-positive hedging flows when yields decline further. All of these factors contribute to a strengthening of an economy's currency over time, which just increases the problems of the central bank. In other words, these strategic trends are highly persistent in nature.

To translate that to our three strategic factors, consider JPY and CHF illustrated by the charts of this theme. Not only do they stand out positively on risk adjusted real rates (chart 1.3) and relative unit labour costs (chart 1.4) but they also have very sizable net debt investment positions; i.e. Switzerland and Japan own more foreign portfolio assets than foreigners own of Swiss and Japanese equivalents (chart 1.8). This mechanically results in selling of foreign currency and buying of CHF and JPY.

The consequence for 2021? Positioning for a weaker CHF and JPY can never be a strategic trade unless one has identified a permanent shift in the central bank's reaction function *or* a shift lower in net savings (S-I). This is one of the key questions for next year. Will higher government spending and more forceful central bank easing push S-I lower, inflation higher and ultimately long-end yields higher for the coming years? For now we remain sceptical on the long-term potential, which means we must distinguish the tactical opportunities from playing a reflation theme early 2021 from the strategic trends that suggest:

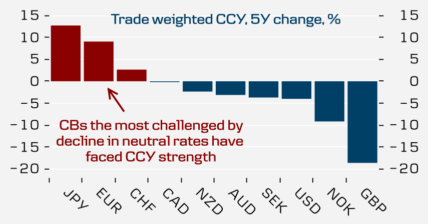
Tailwinds to: CHF, JPY, AUD. **Headwinds to**: TRY, HUF, CZK. **Neutral**: USD, EUR, SEK. On the other hand, when the reflation theme thrives and yields and equities move higher, hedging rebalancing flows favour SEK, GBP and AUD at the expense of CHF, EUR and JPY. The opposite holds true if yields decline and equities sell off.

Chart 1.5: Central banks remain under heavy pressure



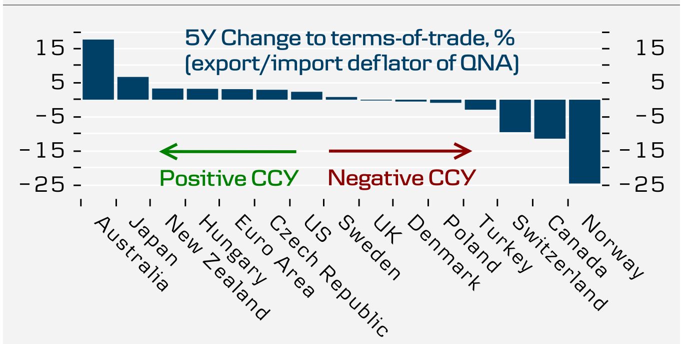
Source: Macrobond Financial, Danske Bank

Chart 1.6: If central banks fail to ease sufficiently they face pressure on exchange rates



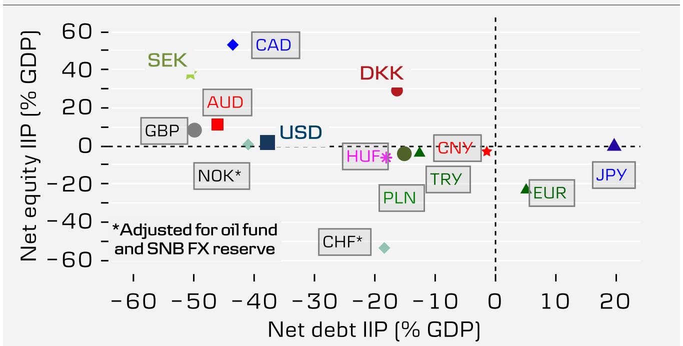
Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 1.7: Terms of trade overview



Source: Macrobond Financial, Danske Bank

Chart 1.8: NIIP hedging flows: higher global yields entail CHF, JPY and EUR selling but GBP, SEK and NOK buying



Source: Macrobond Financial, Danske Bank

Theme #2. Road to oil market recovery

- **We look for the oil price to recover further towards USD60/bbl in 2021.**
- **The oil market will make a comeback following introduction of a vaccine and full reopening of economies in H2, but a lot of supply will have to be absorbed first.**
- **The long-term prospects of the oil market remain bright as world energy demand will continue to grow on the back of a growing and wealthier population.**

Light at the end of the tunnel

Oil consumption has suffered a substantial blow on the back of the pandemic. The drop has been felt across the world economy, although it has been relatively bigger in OECD countries, in particular Europe and the US – see chart 2.3. Recent news on the vaccine front does provide some light at the end of the tunnel for the oil market.

The market will likely have to endure the impact from more restrictions over the winter, but once a vaccine hits the market, we see prospects of market conditions returning to normal. It will not happen overnight; rather we would expect the eventual recovery to take a couple of years. The refinery market is also gradually adjusting to the pandemic circumstances as seen from the jet fuel crack spread, which has turned slightly positive again, but still miles away from the pre-coronavirus normal (see chart 2.1).

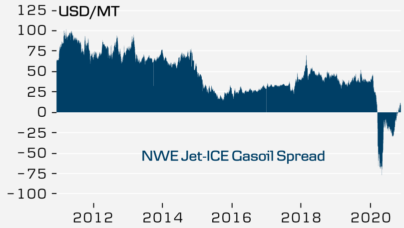
The broad USD has dropped more than 5% this year and partly mitigated the negative impact from the pandemic on demand. We have a broadly neutral view on broad USD in the medium term. Hence, broad USD is neither positive nor negative for the oil price in 2021.

Growing OPEC+ impatience

OPEC cut output to the lowest level since the early 00s as the COVID-19 shock hit and even though output dropped elsewhere, notably in the US and non-OPEC, OPEC's market share is historically low (see chart 2.4). Although the cartel has shown strong commitment to support the oil market, the situation is unsustainable for the cartel in the long run – just look at the difference between the current oil price and Saudi Arabia's fiscal breakeven oil price to see it is no free lunch for OPEC to cut output (see chart 2.2). As demand eventually recovers, the market will likely have to absorb rising output from OPEC along the way.

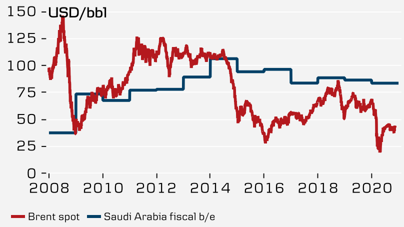
We hold a mildly constructive view on the oil price in 2021 and target Brent crude at USD60/bbl in Q4 21. We do not expect the recovery to firm before sometime during H2 following a vaccine and full reopening of economies.

Chart 2.1: Jet fuel crack spread is positive again



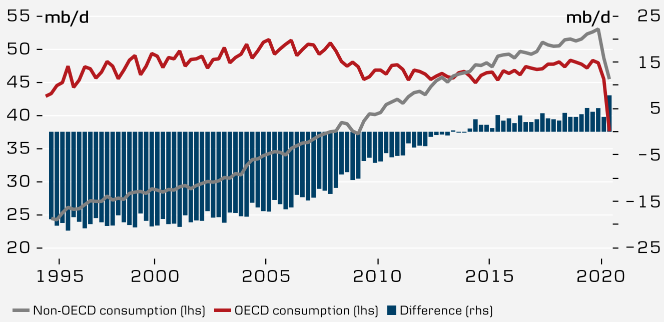
Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 2.2: Unsustainably low oil price for the Saudis



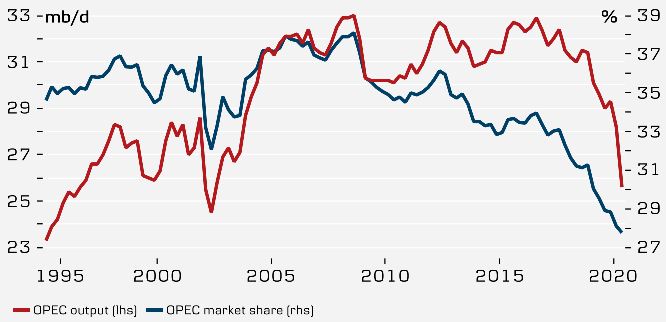
Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 2.3: Consumption has dropped the most in OECD countries



Source: Macrobond Financial, Danske Bank

Chart 2.4 : OPEC will not accept such low market share in the long run



Source: Macrobond Financial, Danske Bank

Restart of shale oil production

US shale oil production has taken a big hit, falling as much as 2mb/d (chart 2.5) culminating in a brief visit to negative prices in April. The US oil rig count looks to have bottomed at almost a fourth of the pre-coronavirus level. We have yet to see clear signs that drilling and production have started to recover.

The breakeven production price for Bakken shale oil is around USD50/bbl according to Rystad Energy. Hence, WTI needs to recover by about USD10/bbl before drilling starts to become economical again (see chart 2.7). With the prospect of a return of up to 1.5mb/d of shale, any price recovery will slow and is an additional reason why we are looking deep into 2021 before we expect markedly higher prices.

Furthermore, it remains to be seen how easy a restart of shale oil production will be – it has never been done before. In the bigger picture, the struggle of producers outside OPEC+ and resulting lack of new investments could provide a case for a tight oil market and a price overshoot down the road, e.g. in 2-4 years' time.

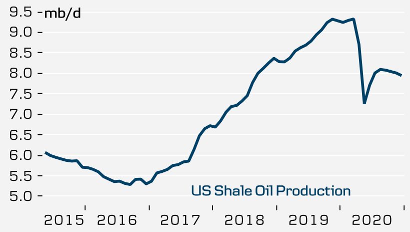
Long-term prospects for the oil market remain bright

The world population continues to grow, as does GDP/capita. Growth in both variables is particularly strong in Emerging Markets. Importantly, the pandemic has not changed this. In our view, it provides a strong back drop for the oil market in the long term – a larger population will demand more energy and a larger wealthier population will demand even more energy (see chart 2.8).

In our view, it is not so much about the competition between oil and other energy sources, i.e. renewables, but rather how they complement each other in satisfying the growing world energy demand. Hence, the growing focus on climate change and renewable energy does not mean 'an end' to the oil market any time soon in our view, but demand growth will primarily come from Emerging Markets.

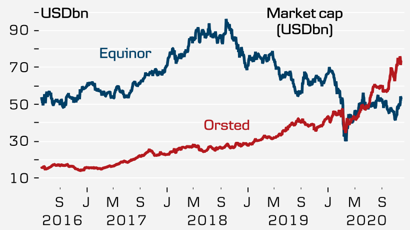
We do see a number of interesting themes in the renewables versus oil space, which will be on our research agenda the coming year. Look at the shift in dominance between the two largely state-owned energy companies in the Nordic, Equinor and Ørsted, this year (see chart 2.6). In particular with respect to the latter, a further push towards renewables will help further firm strong public finances in Denmark and underpin the strong DKK and resulting low rates.

Chart 2.5: Big hit to US shale production



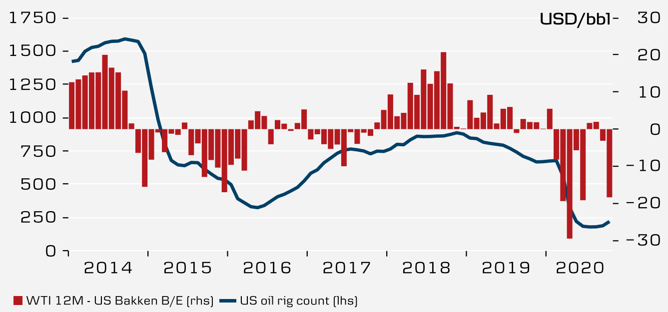
Source: Macrobond Financial, Danske Bank

Chart 2.6: Green wave



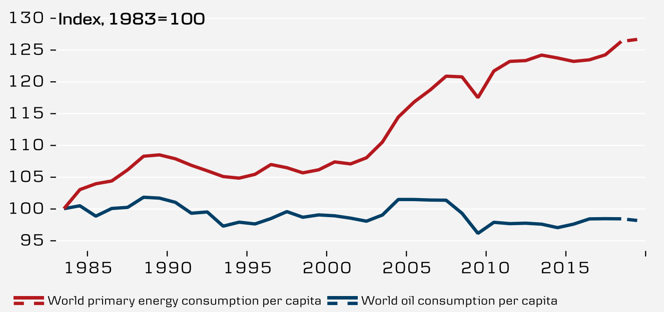
Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 2.7: US oil rig count bottoming out



Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond Financial, Danske Bank

Chart 2.8: Growing world population and growing energy demand



Source: Macrobond Financial, Danske Bank

Theme 3. USD cycle – stretched positions, no regime shift

- **The current cycle of USD uptick remains intact.**
- **China's continued deleveraging will support USD versus European FX.**
- **We like to pick up USD after substantial but cyclically induced weakness this year.**

Every year, we do the same exercise. Look at valuations, discuss PMIs, consider central banks and add politics. Sometimes it works and sometimes it does not and as per *Theme #1*, we believe it is crucial to separate trend from fluctuations. The broad dollar indisputably remains crucial for global monetary conditions via USD-pegs and USD-denominated debt, commodities and trade invoices. Weakening USD will normally both reflect and contribute to outperforming earnings estimates in Europe and Emerging Markets, steeper global rates curve, rising inflation expectations as well as rising commodity prices. The direction of broad USD is a key summary as well as contributor to asset allocation and FX views alike.

An initial observation when forecasting the USD longer term is how remarkably persistent changes in the USD historically have been (chart 3.3) - hence the term 'USD cycles'. With the end of Bretton Woods in the 70s, we have gone through much volatility but only a handful of swings in the dollar. We argue the USD remains structurally supported. In turn, we see limited scope for further broad dollar weakness as we go in to 2021.

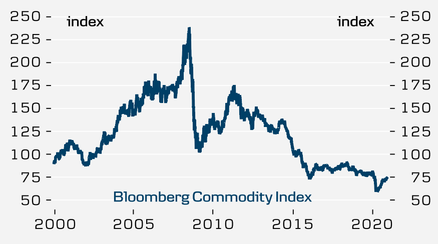
The trend in the price of the dollar, nominally, was on a fairly one-way street up till about the dot-com crash in the early 00s as, largely speaking, inflation differentials dominated (chart 3.3). However, since then, inflation has generally come down in both EM and DM alike and even more so in recent year(s). This leaves real factors as key and we argue this will persistently remain. While some believe the ghost of inflation may come back to haunt the USD itself, we are less convinced if it can really be all that straightforward (chart 3.2).

Regions matter: Asia looking ahead but Europe, EM less so

The current cycle in broad USD was initialised in the early-to-mid 00s by China's rapid industrialisation where rising industrial production, earnings and commodity prices proved the right cocktail that favoured Europe, Scandinavia with its oil and heavy exposure to capital goods as well as Latin America. Equally, the US equities underperformed the rest of the world (chart 3.4).

However, since the financial crisis, China has been silently deleveraging in the background and recently confirmed it will continue to do so (chart 3.5). This has asserted a great negative productivity as well as terms-of-trade shock on all countries outside of 'manufacturing-Asia' and the US. In fact, the corporate winners of today and likely also tomorrow remain mostly to be found in the US as well as in and around China.

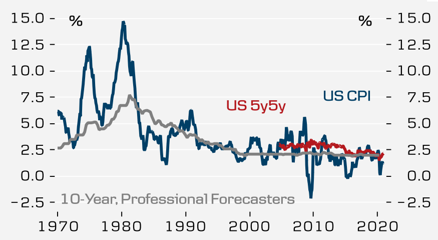
Chart 3.1. Commodity cycle still weak



It is not possible to invest directly in an index.

Source: Macrobond Financial, Danske Bank

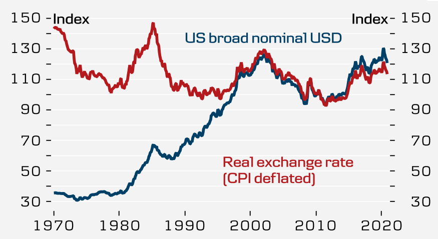
Chart 3.2. Inflation has yet to shift range



It is not possible to invest directly in an index.

Source: Macrobond Financial, Danske Bank

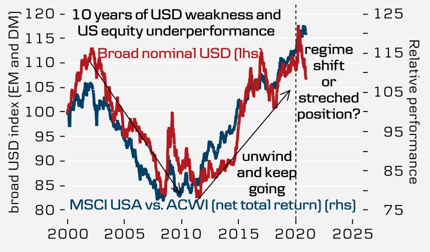
Chart 3.3. Broad USD has not convincingly shown turning point. Secular trend remains persistent.



It is not possible to invest directly in an index.

Source: Macrobond Financial, Danske Bank

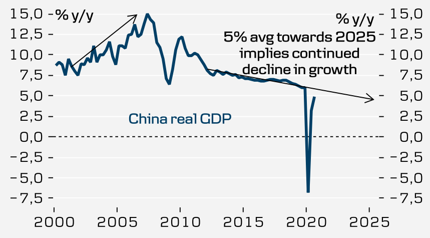
Chart 3.4. Broad USD vs. equities



It is not possible to invest directly in an index.

Source: Macrobond Financial, Danske Bank

Chart 3.5. Chinese deleveraging tbc



Source: Macrobond Financial, Danske Bank

The USD-straddle of 2021: back to the old ways… or new regime

Historically, USD appreciation cycles have come to a halt when one or a combination of the following things occurred.

1. A US recession alongside forceful Fed easing and non-US fiscal easing as per 2000-08 and/or including a positive change in global supply chains (i.e. China).
2. A political agreement to weaken the USD as per the Plaza Accord in 1985, or
3. The upending of the global monetary system a la Bretton Woods in the 70s.

As per chart 3.3, there have been only three turning points for broad USD since the 70s. Firstly, ending Bretton Woods in the early 70s. Secondly, the interventionist policies following the Plaza accord marked a turning point in the 80s and the Chinese industrialisation was the most recently confirmed peak in broad USD, in the 00s.

Arguably, a fourth bullet should be added to this, where US inflation outperformance in tandem with (1)'s non-US fiscal easing combined adds to a rotation out of USD in 2021 as US assets lose out on relative attractiveness. **If we are at the brink of such a regime shift, the discussion of weak fundamentals in EM, Scandinavian FX and even Europe is immaterial. The USD weakening can drive another 10-20% move (subject to ccy).**

Potentially, we are now witnessing the beginning of a regime shift via (1), many will argue. As a response to COVID-19 global central banks – most prominently the Fed – have eased monetary policy aggressively and non-US economies have eased fiscal policy significantly much unlike the years following the great financial crisis. History tells us this is a potential trigger for a global shift in the investment environment. Where could we be heading? Higher inflation is negative for a currency and the biggest valuation correction potential is in US assets and the USD given the imbalances built up over the past decade. If the global policy responses to COVID-19 over the coming year(s) bring about a shift in the USD, this could have huge implications for inflation (and vice versa) as a weakening of the USD will help trigger a period of rising commodities and cost-push inflation.

However, the case for a regime shift has been fading over recent months, we believe. Firstly, as described in detail in Theme #5, we see the tailwind of Chinese fiscal easing as fading. This leaves an open question whether easing elsewhere may take over. Over the recent decade, this has never happened. We speculate that to some extent, the risk is rather skewed in the direction where positive vaccine news ends up being negative by removing the immediate need for politicians to act, in Europe as well as the US. Secondly, we do note for example the ECB has moved over the past month(s). Initially, we were talking about a 'big December package', Bazookas and similar historical references. In practice, the ECB has now backtracked to (at the time of writing) looking more like just adding a bit to its purchase programmes. Simply put, this is highly unlikely to materially change the growth and inflation outlook for Europe and if anything might be marginally negative for market participants' view. Relatedly, the Fed remains committed to average inflation targeting but actions have so far proven less convincing. Since announcing its new regime, we have mostly seen comments related to the fact that Fed stands ready to act, but has not deemed it necessary. Further, the US economy seems to be weathering things well and maybe even better than Europe. In addition, there is a risk that we end up with yet another realisation that US real rates should continue to diverge from Europe, supporting USD.

As we look into 2021, **the broad USD has weakened quite a bit but we view this as noise, not trend**. Rather, the secular forces remain in play: the world wants future-proof companies, less commodity exposure and political stability. In practice, these things remain to be found in the US and Asia. The scope for further broad USD weakness seems limited.

Theme #4. USD money market lull to end in 2021

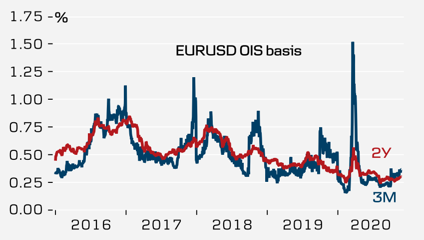
- **EURUSD OIS basis curve is pricing cheap USD for some time to come – we think that is a stretch and the market could be tested already next year.**
- **The long list of unconventional monetary policy measures along with temporary relaxation of some regulation will not continue forever.**
- **The pandemic has not changed the fundamental flow of foreign capital to the US; hence, USD FX hedging demand will continue to grow.**

Tight EURUSD OIS basis will not prevail post-coronavirus

EURUSD OIS basis trades close to tightest level in post Basel III era, year-end looks to be the most calm on record and the curve is flat (see chart 4.1) – more or less where the year started. Nevertheless, 2020 delivered the biggest widening of basis since the financial crisis. It should serve as a reminder for the market, as it prices current very easy funding conditions to prevail for some time to come.

We see a case that volatility could return to EURUSD OIS basis next year, when the world economy and money markets begin a return to normal after the introduction of a vaccine and a reopening of economies. Below we analyse three themes for 2021, which feed into this view: (1) the outlook for USD liquidity, emergency liquidity facilities, temporary suspension of regulation etc., (2) cross-border capital flows and relative fiscal policy in US and euro area and (3) the footprint of a new Biden administration.

Chart 4.1: Tight basis; flat curve



Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial, Danske Bank

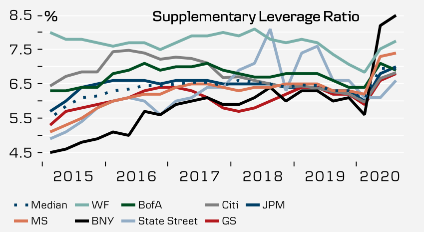
#1. Surge in USD liquidity in H1 next year - then what?

We expect the Federal Reserve to continue QE (and thus add to USD liquidity) and potentially scale it up from the current USD120bn/month pace of Treasuries and MBS purchases. Eventually, the US Treasury's cash balance will be drawn down to around USD800bn, which adds another c. USD700bn of liquidity. All other things equal, total USD liquidity is headed for the USD5,000bn mark around mid-2021 (see chart 4.3).

More USD liquidity means cheaper dollars in H1, but we have a hard time seeing basis tighten much further than it already has. It will be interesting to see how well banks absorb the unprecedented amount of liquidity. In particular, if the temporary suspension of inclusion of reserves and Treasuries from supplementary leverage ratio end next year (banks SLR has increased as seen in chart 4.2). If it turns out to be an issue, Fed has the option of hiking rates on its reverse-repo facilities and lure in excess liquidity from money-market funds and foreign central banks, thereby easing the strains on banks.

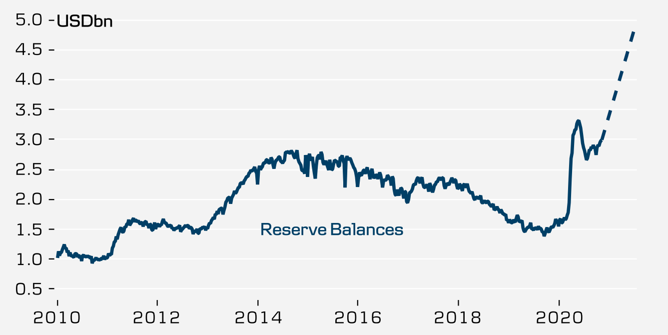
Speaking of an end to the temporary relaxation of regulation: when it ends, the market will likely start to price a higher premium on USD over quarter ends and in particular year ends again.

Chart 4.2: US GSIBs have lots of capital due to temporary easing of regulation



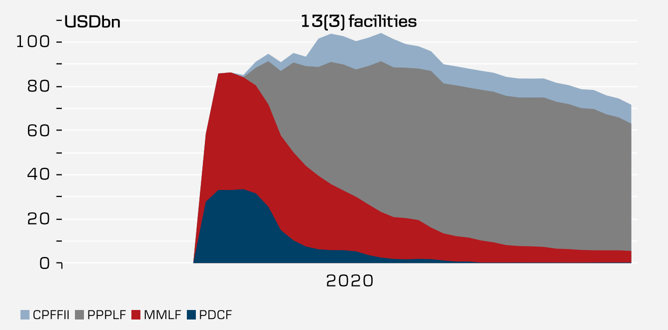
Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial, Danske Bank

Chart 4.3: USD liquidity to skyrocket



Source: Macrobond Financial, Danske Bank

Chart 4.4: Emergency facilities to be extended



Source: Macrobond Financial, Danske Bank

When the Fed ends QE at some point in the future, the return to normal liquidity conditions may also pose a challenge – keep in mind the pre-coronavirus normal was around USD1,500bn in total USD liquidity. Even though the starting point for a period of quantitative tightening is high, a gradual vapouring of liquidity may be enough to stir up the money market.

Banks' liquidity demand is also a function of the temporary restriction on stock buybacks and dividend payments from the Fed. It is set to end on 31 December, if not extended for another quarter. When it ends, we could see some temporary turmoil in the money market, as banks return excess liquidity to shareholders. The Fed will likely wait until the end of December to announce a decision as it did in Q3. Note that banks hold 35% of their assets in USTs, cash etc. from 28% pre-coronavirus.

The Fed's laundry list also includes an extension of the central bank USD swap facility, which ends on 31 March. Fed has already extended some of the section 13(3) emergency facilities, which account for close to USD70bn in various liquidity and credit facilities (see chart 4.4). The swap facility is little used (see chart 4.5), but still it is an easy decision to extend it another quarter until after a vaccine is introduced. The Fed may opt to make the terms slightly less favourable on the swap facility as part of an extension, e.g. hike the rate on the facility from the present OIS+25bp, which will open up the trading range for basis. In all cases, there is ample USD liquidity to replace the need for the facility if it is not extended. A decision will likely not be announced until well into Q1.

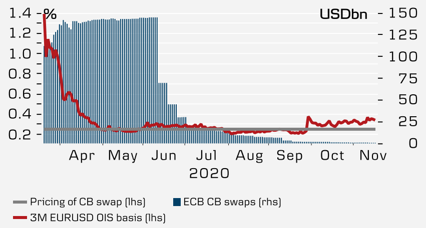
#2. US continues to attract foreign capital

The US current account deficit in Q2 was the largest since Q4 08. In other words, more capital is flowing to the US under the pandemic, not less (see chart 4.7). An important point here is that the public deficit in US looks to easily beat the already large deficit in the euro area this year and next (see chart 4.6). Fundamentally, the drivers of the large deficit and capital flow to US, i.e. demography, should not be materially affected by the pandemic. Hence, investors outside US will continue to demand USD assets and have a need to hedge the USD FX exposure, which keeps a prerequisite for a wider basis.

#3. Deregulation agenda put on hold

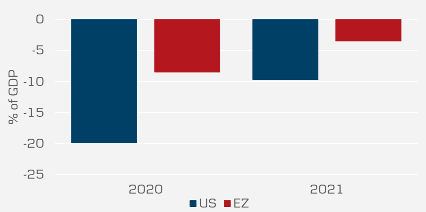
The Biden administration will likely also make an indirect footprint on the USD money market. First off is the pick for Treasury secretary, former Fed chair Janet Yellen. We expect her to support Fed's current 13(3) facilities and a possible further extension, but she will likely have a more centrist view on regulatory matters. It is also doubtful whether Fed vice-chair responsible for supervision, Randall Quarles, will continue in this role when it is up in October. Overall, there could be a good chance the deregulation agenda is put on hold under the Biden administration – another prerequisite for a widening of basis again.

Chart 4.5: Little use of USD swap facility in euro area



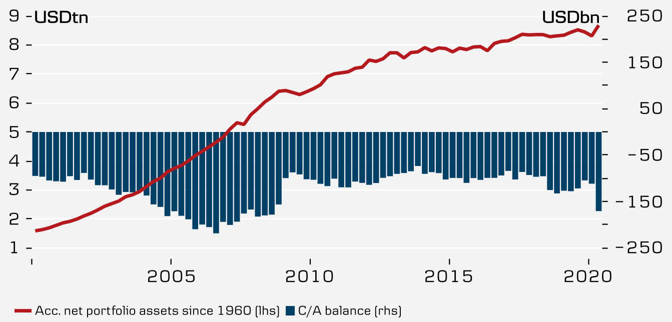
Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial, Danske Bank

Chart 4.6: Public deficits: EZ and US



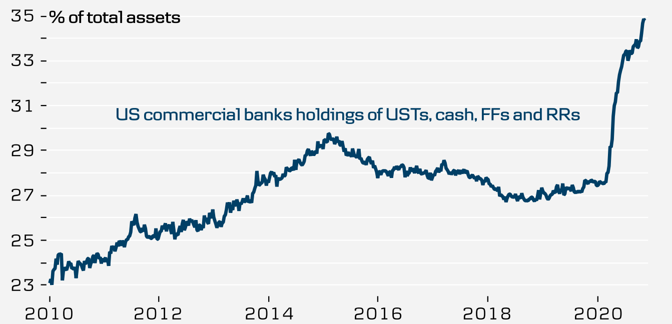
Source: Macrobond Financial, Danske Bank

Chart 4.7: Capital flowing to US



Source: Macrobond Financial, Danske Bank

Chart 4.8: Banks awash with liquidity



Source: Macrobond Financial, Danske Bank

Theme #5. Peak in the China cycle

- **After a robust post-COVID-19 recovery we believe the Chinese cycle is close to a peak. With more solid ground under the economy focus will now return to deleveraging and policy exit.**
- **With a moderation in growth, China will switch from a growth booster to growth dampener in the global economy next year.**
- **Scandies, EUR/USD, ZAR and other fragile Emerging Market currencies are likely to face substantial headwinds as China-tailwind fades.**

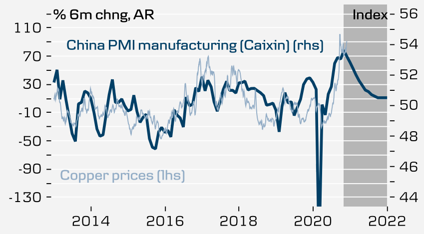
Strong Chinese recovery to shift down a gear in 2021

After taking a huge hit to the economy in Q1 following the COVID-19 outbreak, China has staged a strong rebound since then. Manufacturing PMI from Caixin hit the highest level in nine years, industrial production pushed back up to around 7% y/y and retail sales have gradually gained momentum throughout the year. The housing markets and exports also recovered quite briskly.

The recovery has been driven by mainly three factors. First, as China got the COVID-19 virus under control the economy had a lot of catching up to do from the extremely depressed activity levels in Q1. Production levels increased sharply as factories reopened and consumption picked up as people could again go to the shopping mall. Second, China added a decent amount of stimulus by lifting infrastructure investments, cutting taxes and fees and lowering interest rates. It added impetus to investments, home sales and consumption. Finally, during the summer and autumn exports saw a boost from the recovery in the US and Europe, which recovered from their first wave of lockdowns.

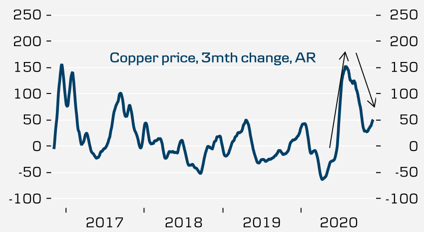
Looking into H1 21, we believe all three engines of growth are fading. The initial catch-up effect is increasingly behind as the economy has been ‘normalising’ for some quarters now. Importantly, China has also changed its focus in the economic policy from stimulus to exit. The COVID-19 crisis forced China to put the ongoing deleveraging on standby and instead debt expanded again. However, the renewed rise in debt has only increased the need for a period of deleveraging and Chinese leaders seem much focused on returning to a path of reducing financial risks.

Chart 5.1: Strong post-COVID-19 recovery but peak is close



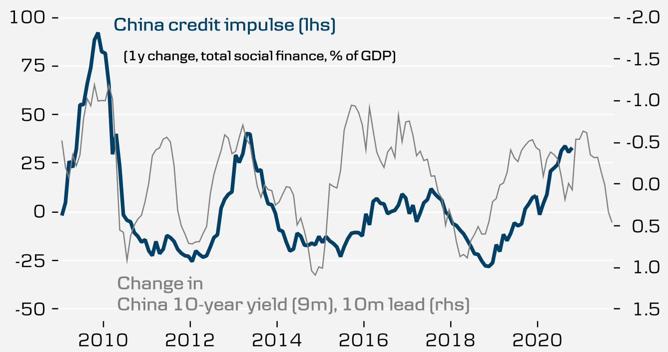
Source: Macrobond Financial, Markit, Danske Bank

Chart 5.2: Copper price still rising but momentum has come down



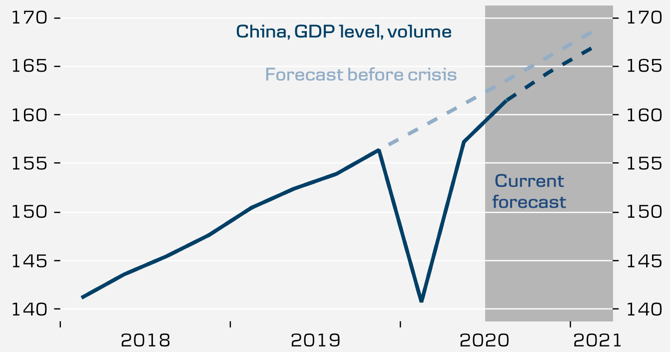
Source: Macrobond Financial

Chart 5.3: Credit impulse to peak in Q1 as deleveraging returns



Source: Macrobond Financial, PBoC

Chart 5.4: GDP has regained a lot of ground but momentum is set to slow down as much of the output gap is closed



Source: Macrobond Financial, Danske Bank

PMI is close to a peak as growth settles down

As chart 5.1 shows we look for PMI to be close to a peak and decline gradually from here. It reflects our view that momentum in growth is set to move from very high to something more moderate. The moderation in growth implies that China will change role from a growth booster in 2020 to a growth dampener in 2021.

While we look for a slowdown, we do not forecast a new sharp downturn in the Chinese economy. Rather we project PMI to decline gradually from elevated levels but to stay above the long-term average during 2021 (see chart 5.1). Not least because we look for the US and Europe to recover from Q2 and onwards as a COVID-19 vaccine is rolled out, unleashing pent-up demand in both investments and private consumption.

Chart 5.5: Lift to Chinese car sales settling down

Source: Macrobond Financial, NBS

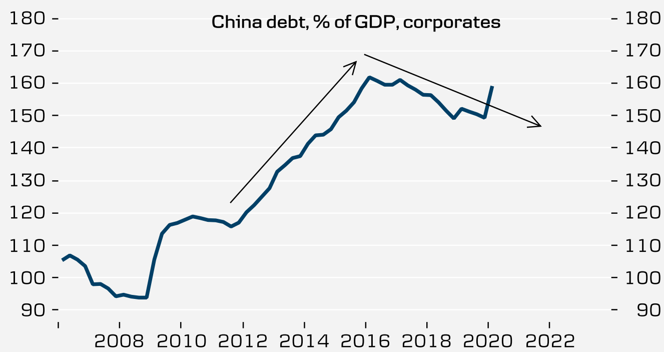
Fading China makes broad USD great again…

The rebound in China has been pivotal for strength across CNH, ZAR, JPY, EUR/USD and Scandies alike as these countries have faced either (1) a strong improvement in the terms of trade via industrial and metal prices and/or (2) have faced a similar uptick in exports through capital and/or consumer good exports.

As per chart 5.3, the global economy has faced similar tailwinds to what we have seen post-COVID-19 on other occasions (2012, 2016), which eventually faded into broad USD strength.

In our view, the fading of these tailwinds is likely to materially change the trajectory of e.g. USD/ZAR and/or USD/SEK in favour of a reversal towards trend (strong/stronger USD), during 2021. Other regions, such as the US and Europe should for a while be able to easily offset the fading Chinese tailwind. However, as we move further into 2021, our view on China is a key underpinning for why we see and expect more USD strength, currently forecasting EUR/USD at 1.16 in 12M time, rather than having leaned into the consensus story at 1.21.

Chart 5.6: COVID-19 put deleveraging on pause – set to continue again soon



Source: Macrobond Financial, BIS

Chart 5.7: Strong export recovery likely to hit a soft patch in Q1 as the US and Europe slow temporarily

Source: Macrobond Financial, Markit

Eight FX Trades

Trade #1. Short EUR/NOK via options

- **Position for stronger NOK on reflation and domestic characteristics.**
- **Seasonal pattern favours stronger NOK in Q1 after vulnerable Q4.**
- **We like risk-reward offered by 3M 10.4500-11.000 risk reversal (zero cost).**

A high-beta derivative of the global reflation theme ...

To us the NOK is one of the most direct ways in FX majors' space to play a view on the global reflation theme (growth, inflation, commodities, curve slopes) – in either direction. As chart 6.1 shows NOK has been among the top performers during periods where the reflation theme has accelerated, while also among the biggest losers when the opposite has been true. A correlation and beta analysis shows that over the past year - especially true during the COVID-19 crisis - NOK has had a far larger sensitivity to global equities, value sectors, curve slopes and commodity prices than relative rates. We expect that to continue, leaving NOK a clear vaccine/reopening trade for 2021 overall. As physical demand picks up, not least oil and gas prices are set to eventually enjoy support (Theme #2) and while the topside seems limited by shale/OPEC+ supplies and the level of the trade-weighted USD, we still think NOK is set to benefit from vaccines bringing us back to normal.

... with domestic and seasonal attractiveness

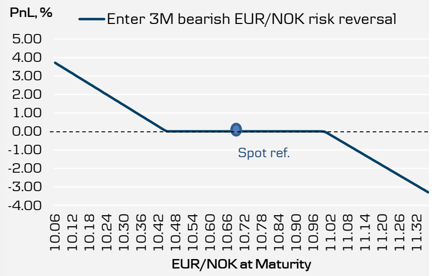
What is more, NOK underperformance this autumn is likely also attributable to seasonal fears, as we still hear many foreign investors cautious of entering long NOK positions in Q4. This might explain why our EUR/NOK BEER-model (valuation) estimate - based on relative rates, curve slopes, equity sector performances, oil and salmon prices - is below current spot. That suggests an eventual 'catch-down' potential in the cross. In *Reading the Markets Norway*, 22 October, we gave more colour on this seasonal aspect. In short, we think this is mostly a liquidity vulnerability to external events and psychological fears leaving a very left skewed return distribution in Q4. On the other hand, NOK tends to strengthen in Q1 as spot liquidity improves, investors put on new positions and as structural liquidity tends to decline on Norges Bank's NOK purchases in Q1. That is why NOK tends to weaken in Q4 and strengthen in Q1. We think this will happen again and expect Norges Bank to lift its NOK purchases again next year to a level of c. NOK1.6bn/day.

Due to year-end liquidity issues, which can make for temporary NOK sell-offs, we prefer options as a means to position for Q1 NOK strength. Last year showed how NOK need not weaken in Q4, yet we still like the risk-reward of positioning for a stronger NOK delivered by 3M 10.4500:11.0000 risk reversal. We set a spot stop-loss of 11.2000. The biggest risk to this trade is a setback in global risk appetite, as this would hit the reflation theme and by extension NOK. Examples of such are less policy support, poor vaccine news and a faster peak in Chinese activity. That said, in our base case we like the 3M risk-reward.

Trade #1. Short EUR/NOK

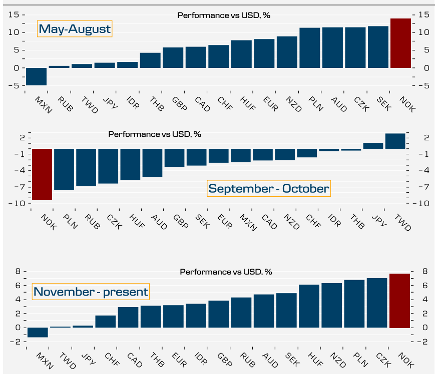
Short EUR/NOK 3M risk reversal

Entry date	2 December 2020
Strategy	Buy 3M 10.4500 put
	Sell 3M 11.0000 call
Spot stop:	11.2000
Spot ref:	10.7019
Cost:	Cost neutral (indicative prices)



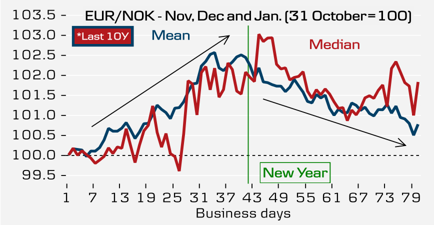
Source: Bloomberg, Danske Bank

Chart 6.1: NOK stands out as extremely sensitive to global reflation theme



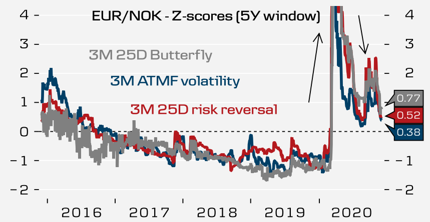
Source: Macrobond Financial, Danske Bank

Chart 6.3: Seasonality in favour of stronger NOK in Q1



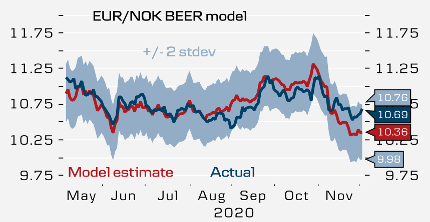
Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Chart 6.4: We like the risk-reward made possible by a risk reversal



Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Chart 6.2: We believe in 'catch-down' effect



Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Trade #2. Short EUR/USD via options

- **Chinese deleveraging tbc, bottoming EUR/USD basis, the potential for rising US real rates, valuation and continued technological divergence to weigh on spot.**
- **We go short EUR/USD via 6M seagull, betting against the general consensus.**

Since the US election, vols have compressed and the value rotation has continued. To some, but very limited extent, this has also lifted EUR/USD a tad higher. We suggest to utilise this to go short EUR/USD via 6M seagull at zero cost (indicative prices).

Mind the uniqueness of EUR/USD versus broad USD

On several of the vaccine-announcements (Pfizer, Moderna), we have seen rising US rates, commodities being underpinned and many value sectors being up 3-5% a day, while the 'stay-at-home' stocks got sold. However, this rotation has really not affected EUR/USD, unlike what happened after the March COVID-19 shock. To us, these are event studies showing how the market no longer views spot as cheap. Indeed, gauging from our own valuation models, we get results from 1.08 (chart 7.1 on relative asset pricing on value versus growth in equities) to around 1.20 on PPP. It is our general view that EUR/USD lacks cyclicality vis-à-vis e.g. ZAR, SEK or NOK, which in turn means it is not too difficult to see a modestly lower EUR/USD even amid a global cyclical recovery.

Short EUR/USD on China, valuations, structural trend

In addition, we generally see short-term indicators as being stretched long in e.g. positioning (chart 7.2) and the 'recovery trade'-narrative is quite consensus by now. Thus, the surprise potential appears to be for the downside in EUR/USD, just like in 2018.

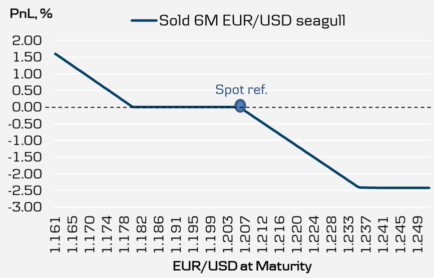
In *Theme #1*, we argued to separate trend from deviations. Indeed, we would say EUR has strengthened this year on the back of a lack of 'catastrophic events' and thus, it has been the removal of (global) debt-deflation tail risks, which have helped the single currency substantially (chart 7.1). We still view the USD cycle as intact (*Theme #3*), there is likely a peak-China story forming in 2021 (*Theme #5*), plus we see risks in favour of wider USD basis (*Theme #4*). In addition, political disagreement in Europe (the EU budget) has shown that the EU is still an in-coherent collection of nation states. Further, from an investment perspective, we do still view US (and non-commodity Asia) as the global winners, whereas European companies are laggards, supporting USD.

We suggest to go short EUR/USD via a seagull - betting in the direction of the trend from a tactically stretched position and taking advantage of the decline in volatility and cheap wings (chart 7.3). We choose to go short spot via a 6M seagull (long tenor, known worst case) as we do recognise it could take a few months before markets decide for a new story and Q1 could propel us a bit higher still. Key risks to this trade include a renewed, strong reflationary momentum and/or that European macro is stronger than we anticipate.

Trade #2. Short EUR/USD

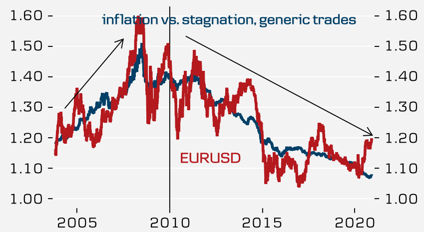
Sell 6M EUR/USD bullish seagull

Entry date	2 December 2020
Strategy	Buy 6M 1.1800 put
	Sell 6M 1.2059 call
	Buy 6M 1.2350 call
Spot stop:	N/A - downside floored
Spot ref:	1.2059
Cost:	Cost neutral (indicative prices)



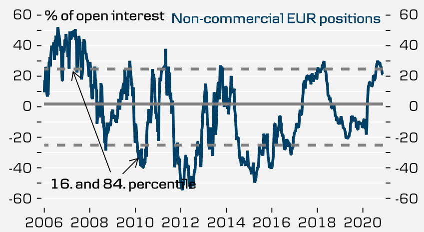
Source: Bloomberg, Danske Bank

Chart 7.1: Asset rotation underpins weaker EUR/USD over time and is not cheap vis-à-vis alternative trades



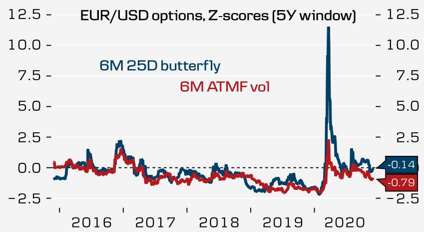
Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Chart 7.2: Positioning stretched long



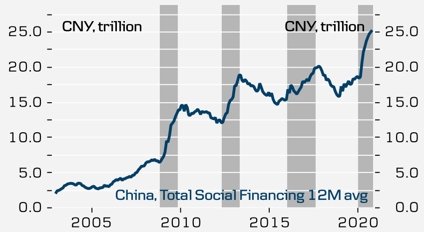
Source: Macrobond Financial, Danske Bank

Chart 7.3: Vols and wings lower again



Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Chart 7.4: China has been big boon



Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Trade #3. Long USD/SEK via options

- **Risk-reward favours the upside in USD/SEK.**
- **Allocation trends continue to favour the US.**
- **We recommend entering a 6M long call spread in USD/SEK.**

SEK rally starting to look stretched...

Since late March peaks, USD/SEK has dropped more than 20% bringing the cross back to early 2018 lows. While we acknowledge the risks of trying to catch a falling knife, we see risk-reward - not least considering the degree of positivity priced in, limited USD downside and positioning - increasingly favouring the topside in USD/SEK.

... and current valuation leaves no room for disappointments

With EUR/SEK and USD/SEK both trading at multi-year lows in the midst of the second wave of the pandemic, to postulate that the SEK has priced in almost exclusively benign news from hereon is no overstatement in our book. Especially considering that we are likely in for a setback in terms of European growth during Q4-Q1 on the back of tightened restrictions and a still rising spread of the coronavirus across the globe. *A lot of good news is priced in the SEK in our view, which leaves it vulnerable to negative surprises.*

So far this year the SEK rally has been met with indifference on behalf of the Riksbank, implicitly lending support to that same rally. However, at the November meeting we noted a slight shift in rhetoric. The sharp appreciation was acknowledged and it stressed that if it continues it would hamper inflation prospects and could be a cause for policy action. If so, a revisit of negative rates and currency intervention threats like in 2015, or both, are possible in our view, especially as the prerequisites for a domestically generated inflation look weak given the recently agreed upon lacklustre wage deal alongside the downtrend in inflation expectations. Swedish inflation dynamics and the Riksbank itself should act as a 2021 headwind for substantial SEK appreciation.

Glancing at other medium-to-long-term drivers (*Theme #1*), we see nothing to indicate that the SEK is undervalued. On the contrary, EUR/SEK is currently trading at the lower end of the range posited by our in-house MEVA model, encapsulating trends in relative productivity. Hence, we deem the strategic trend to remain SEK-negative in the coming years. Interestingly, the Riksbank has recently adopted a fundamental stance on SEK valuation similar to our view, namely that the krona is close to long-term fair value.

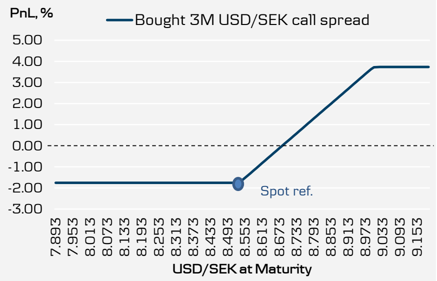
A USD-comeback sets the stage for higher USD/SEK

As for the USD, we find the rumours of its impending demise highly exaggerated. Especially viewed against the EUR, where we still see strategical trends favouring the USD (*Theme #3*). Additionally, EUR/USD has seemingly run out of steam, despite vaccine-induced reflation hopes and tentative sector-rotation towards more EUR-pronounced value stocks, while positioning in the EUR/USD cross remains stretched long. As the global economy is entering a soft patch in Q4-Q1, where especially Europe will suffer, this should weigh not only on EUR/USD but also on the pro-cyclical, high-beta Swedish krona. With EUR/USD set to peak at, or around, current levels, before moving gradually lower in 2021, we deem risk-reward to favour a play on USD/SEK upside in the coming quarters, preferably via options. Specifically, given recent moves in option pricing, we like the risk reward of buying a 6M 8.5328-9.0000 call spread for an indicative premium of 1500 pips. This structure has a break even at maturity of 8.6828 with expiry profit maximised at 3172 pips for spot levels above 9.0000. A key risk to the above is if European growth fares better than feared near term and/or that the USD-negative reflation narrative becomes the talk of the town once again, as that could push USD/SEK even lower on benign risk impulses.

Trade #3. Long USD/SEK

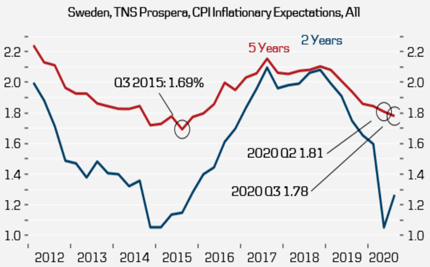
Long USD/SEK via 6M call spread

Entry date	2 December 2020
Strategy	Buy 6M 8.5328 call
	Sell 6M 9.0000 call
Spot stop:	N/A – downside floored
Spot ref:	8.5328
Cost:	1500 pips (indicative prices)



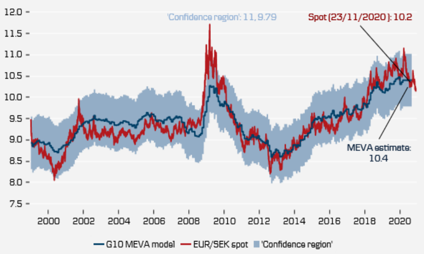
Source: Bloomberg, Danske Bank

Chart 8.1: Keep an eye on inflation expectations



Source: Macrobond Financial, Danske Bank

Chart 8.2: SEK not undervalued



Past performance is not a reliable indicator of future results. Source: Macrobond Financial, Danske Bank

Trade #4. Short EUR/GBP spot

- **EUR/GBP has been on a steady decline since early autumn but we think there is room for further declines.**
- **We think GBP will be supported near-term by a Brexit deal and more positive COVID-19 (vaccine) news.**
- **We enter a short EUR/GBP spot outright position targeting 0.8650 with a stop-loss of 0.9300.**

Still a Brexit risk premium to price out

While EUR/GBP has been on a steady decline since mid-September, when the cross traded at 0.925, we think there is still room left for further declines near term. We see two main reasons for a stronger GBP near term. Firstly, we expect a relief rally in GBP on the back of a Brexit deal, which remains our base case (60%). A deal is also likely to lead to a slight repricing of the Bank of England, where investors are still pricing in a probability of a rate cut into negative territory, which we think is unlikely in case of a Brexit deal. At the time of writing, investors are pricing in a nearly 30% probability of a 25bp rate cut over the next year. Secondly, we think GBP, as a cyclically sensitive currency, will benefit near term from risk-on supported by continued positive vaccine news and easing of restrictions in Europe in spring. There are also other reasons why to expect a stronger GBP. The UK economy has ended its partial lockdown and is now returning to a renewed version of the old ‘tier’ restriction system. We expect the UK economy to outperform the euro area next year, especially since a Brexit deal should unlock pent-up business investments. Brexit remains a top-3 source of uncertainty for UK businesses, which should also be GBP positive. Looking at positioning, it is neutral, also leaving room for a stronger GBP. GBP usually strengthens when the yield curve steepens, as higher yields are associated with GBP buying from a hedging perspective due to negative foreign net debt position.

While we are still optimistic on GBP, there is also a limit to how much EUR/GBP can move lower in the current environment, where a lot of good news is already priced in, both with respect to Brexit and COVID-19 vaccines. We recognise that GBP volatility is not as high as during periods with high financial stress (like in spring with the initial COVID-19 stress) or high Brexit uncertainty (like in October 2018 or August 2019). That said, 3M ATM EUR/GBP implied volatility remains higher than for other cyclically-sensitive EUR crosses like EUR/NZD, EUR/AUD and in particular EUR/SEK. Volatility was trading around the same levels in early 2020 before COVID-19 hit. EUR/GBP 3M vol spread to CVIX is also still a bit high. To us, this suggests that there is still a no-deal Brexit risk to be priced out although the risk premium is not very big.

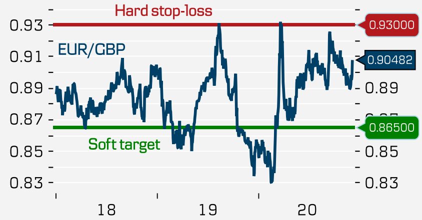
We forecast EUR/GBP trading at 0.86 in 3M but have set our soft target at 0.8650. We put our stop loss at 0.9300, which is above the September tops. This year this level has only been surpassed by March levels when the COVID-19 crisis escalated.

It may be dangerous to make bets on political events and we are admittedly seeing a non-negligible risk (40%) of a no free trade agreement, which would lead to a significant jump in EUR/GBP, in our view. GBP also remains vulnerable to negative surprises in general, as a lot of positive news is already priced in. However, we still like the risk-reward of this trade.

Trade #4. Short EUR/GBP

Short EUR/GBP spot outright

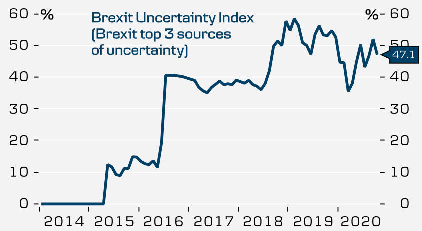
Entry date	2 December 2020
Spot ref:	0.90482
Target (soft)	0.86500
Stop-loss (hard)	0.93000



Past performance is not a reliable indicator of current or future results.

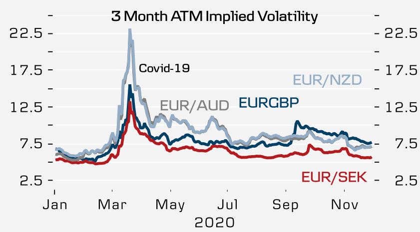
Source: Macrobond Financial, Danske Bank

Chart 9.1: Brexit uncertainty is still weighing on UK businesses



Sources: Bank of England, Macrobond Financial

Chart 9.2: Volatility is still higher for EUR/GBP than e.g. EUR/SEK



Past performance is not a reliable indicator of current or future results.

Source: Bloomberg, Macrobond Financial, Danske Bank

Trade #5. Short CAD/NOK spot

- **Sell CAD/NOK as commodity-hedged reflation trade.**
- **Oil outlook, neutral rates and state of economies suggest spot downside.**
- **Model estimates suggest downside potential; sell spot with 3M horizon.**

Tactical reopening trade in disguise

While *Trade #1* constitutes a more outright play on a stronger trade weighted NOK, we also like the notion of a lower CAD/NOK. We consider this as a commodity-hedged reflation trade and/or a low delta 'short USD/NOK'. As chart 10.1 shows CAD/NOK correlates negatively to the global reflation theme. When equities rise, curves steepen, inflation expectations move higher and value outperforms growth stocks, CAD/NOK declines. This correlation can be explained by two channels.

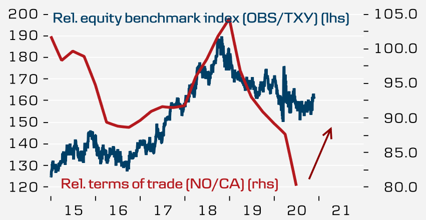
First, the Norwegian economy is more commodity heavy than Canada. That goes in terms of exports, employment, terms of trade and equity benchmark indices (chart 10.4). For instance, while oil and gas make up 14% of Canadian goods exports, this is almost 50% in Norway. That means a larger positive profit impulse into the Norwegian economy when the reflation theme thrives and value stocks perform.

Secondly, the reopening trade favours a faster normalisation of monetary policy in Norway. Both BoC and NB have recently estimated neutral money market rates around 0. However, with both inflation running higher and inflation expectations being anchored at higher levels, Norway has considerably lower real rates (chart 10.2). What is more, so far, the Norwegian economy has – like Scandi peers – been among the smallest losers on the GDP metric, while the Canadian economy has been harder hit. In addition, financial imbalance risks have more focus/weight in Norway and hence we should eventually expect Norway to lead the developed world's hiking cycle. As the vaccine news marks the start of the end game, we expect NOK assets' high beta to the global reflation theme to stand out during the beginning of next year. That leaves a relative rates argument in favour of a lower CAD/NOK for investors believing in a reflation narrative.

CAD/NOK seems elevated to historical drivers; sell spot

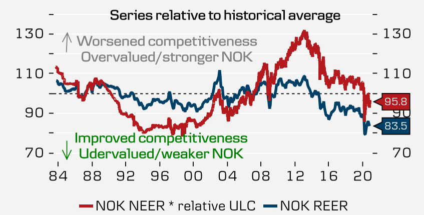
A regression model on short and long rates spread, WCS-Brent spread, VIX, DXY and NBP gas prices explains 85% of weekly CAD/NOK volatility over the past 10 years. That model estimate is shown in chart 10.3 and indicates a catch-down potential in Q1 21. In sum, we like to sell CAD/NOK spot as a semi-oil-hedged play on global growth, relative rates and valuation with the biggest risk here being a global equity sell-off and/or substantial USD strength. CAD is much closer coupled to the USD and the US economy. In turn that means USD/CAD essentially becomes a low beta USD/NOK to external events. We highlight that this spot trade primarily is a trade for early Q1 21.

Chart 10.4: Norway economy more exposed to oil and gas prices…



Past performance is not a reliable indicator of future results. Source: Macrobond, Danske Bank

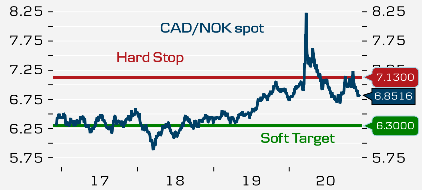
Chart 10.5: NOK no long suffers from same ULC headwinds



Past performance is not a reliable indicator of future results. Source: Macrobond, Danske Bank

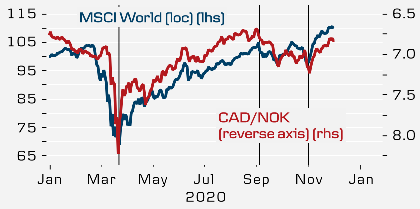
Trade #5. Short CAD/NOK

Short CAD/NOK spot outright	
Entry date	2 December 2020
Spot ref:	6.8516
Target (soft)	6.3000
Stop-loss (hard)	7.1300



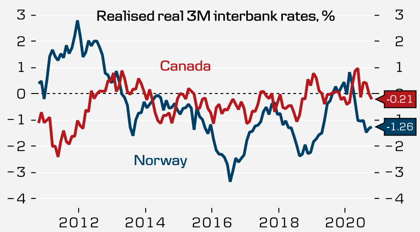
Source: Macrobond Financial, Danske Bank

Chart 10.1: CAD/NOK has a negative correlation to global reflation theme



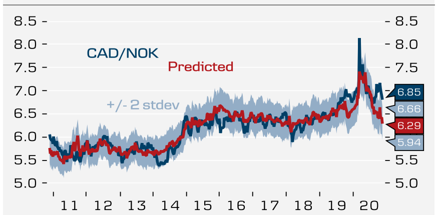
Past performance is not a reliable indicator of future results.
Source: Macrobond Financial, Danske Bank

Chart 10.2: Norway's neutral rate gap to Canada stands out



Past performance is not a reliable indicator of future results.
Source: Macrobond Financial, Danske Bank

Chart 10.3: Valuation gap*



**10Y regression on short and long rates spread, WCS-Brent spread, VIX, DXY and NBP Gas prices*
Past performance is not a reliable indicator of future results.
Source: Macrobond Financial, Danske Bank

Trade #6. Long EUR/HUF spot

- **Hungary's inflation gap to the euro area points to 2-3% y/y drift in EUR/HUF.**
- **Global – plus local – conditions suggest the drift will continue well into 2021.**
- **We go long EUR/HUF in anticipation of further upside at near-zero cost of carry.**

'Same procedure' sometimes pays off – and being long EUR/HUF was our best performing trade of 2020 at +5.5%. This year, we continue to like the case, but, in addition, we highlight that this trade has strong idiosyncratic driver(s). Thus, we do not view the trade as closely linked to a broad USD view, hence providing exposure to a different risk premium.

A prime example of a CPI-induced FX drift

Hungary is a success story of well-executed monetary policy that has managed to drive the labour market close to full employment and achieve higher inflation via domestic demand. Despite loose monetary policy, the Hungarian central bank (MNB) has so far only faced moderate inflation (2-4%), albeit still notably higher than the eurozone's (c.0-1%). As a result, EUR/HUF has seen a sustained CPI-induced drift higher that is likely to continue into 2021. Thus, this trade is a prime example of betting with the (relative inflation) trend.

Following the MNB's monetary pivot in 2012, the Hungarian economy has been on a one-way path: by cutting the policy rate by some 600bp in a matter of years, thereafter keeping yields at very low levels, supplementing with QE, the growth trend has significantly turned for the better. Notably, unemployment moved from 12% to just over 3% and wage growth has gone from 0% to low double digits. This boom in domestic demand has shielded the Hungarian economy from most global forces, including the recent coronavirus crisis.

Coronavirus crisis too shallow to bring down wage-driven CPI

We highlight Hungarian CPI is driven by wages and not commodity prices. For all of Eastern Europe actually, unemployment has simply not risen enough to make inflation keel over and we view the resilience of CEE inflation as parallel to the US's experience of the 70-80s. Thus, the inflation drift is buoyant. In our view, this trade has the risk premium of being 'long CPI', no cost of carry as well as being underpinned by persistency in relative macro fundamentals. It thus has explicitly little to do with the direction of broad USD.

MNB is set to remain dovish in our view. Data is in line with the central bank's expectations. CPI had been running to high at 4%+ but appears to be shifting lower into the middle of the central bank's range, at 3%. This will likely make the central bank step down from hawkish communication. In turn, we expect to see a controlled and moderate drift higher in EUR/HUF at a point in time where there is no cost-of-carry of holding such position. Conversely, the two other central banks in CEE3 could prove to be more hawkish.

Key risk is a hawkish MNB shift

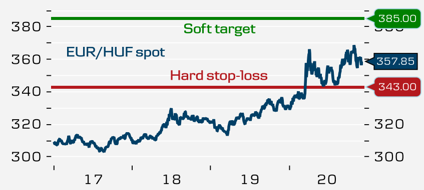
A key pre-condition for this trade is that inflation stays high versus the euro area but well in line with the MNB's expectations. If core CPI moves above the 4% upper range, the MNB would probably act. To the extent that such repricing also credibly tapers Hungarian inflation, HUF would probably be a buy, not a short. In our view, the Hungarian economy is doing well – but the inflation outlook supports the MNB's own view of staying dovish.

This being a trade based on 'fundamentals', we have placed a somewhat wide target-stop to allow short-term conditions to move against us, as we expect this trade to perform over a slightly longer horizon, say, during the course of H1. Needless to say, long EUR/HUF is also a good hedge of a general sell-off as well as for political problems in Europe as HUF is a low-rate, high-CPI cross in a manufacturing-based, small open economy.

Trade #6. Long EUR/HUF

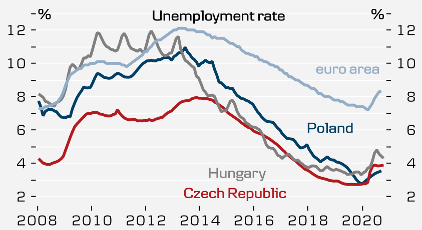
Long EUR/HUF spot outright

Entry date	2 December 2020
Spot ref:	357.85
Target (soft)	385.00
Stop-loss (hard)	343.00



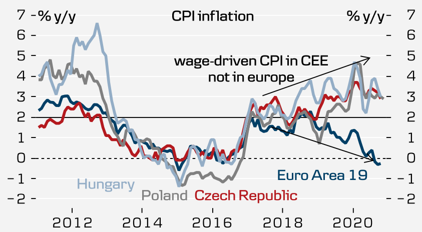
Source: Macrobond Financial, Danske Bank

Chart 11.1: CEE unemployment set to keep wage growth elevated



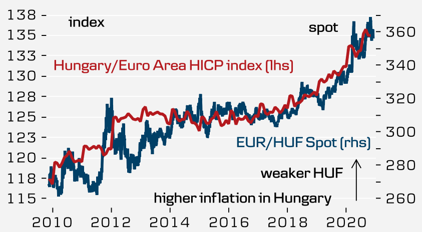
Source: Macrobond Financial, Danske Bank

Chart 11.2: CEE inflation persistently high versus European peer



Source: Macrobond Financial, Danske Bank

Chart 11.3: Relative CPI is key driver for rising EUR/HUF since 2017/18



It is not possible to invest directly in an index
Source: Macrobond Financial, Danske Bank

Trade #7. Long EUR, JPY spot basket

- **Low inflation to be continued even post a COVID-19 vaccine.**
- **ECB and BoJ's inflation creation struggles to continue.**
- **Mimic long trade weighted EUR and JPY vs CNH, USD, GBP and SEK.**

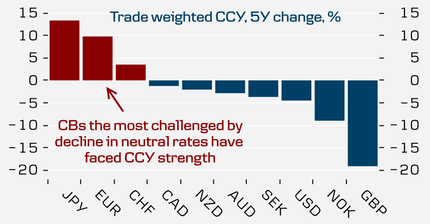
ECB and BoJ not about to create inflation

A range of deflation-haunted central banks will be in for persistent challenges ahead. We note that a winning trade over the past five years has been to be long low-inflation currencies JPY, EUR and CHF (see chart 12.3) versus peers. In our view, this drift will likely continue in 2021 and we therefore go long EUR and JPY versus a well-diversified basket (see chart 12.1). Fundamentally, this trade is driven by drifts in purchasing power parities, i.e. relatively low inflation will tend to appreciate the currency versus others. The key argument for this trade is the ingrained inability of ECB and Bank of Japan to deliver on their respective inflation targets. That is not a new thing – we have talked about that for years. However, we emphasise that the pandemic and the accompanying fiscal and monetary easing are unlikely to change this. The inflation swap market is pricing a persistent inflation divergence between euro area and Japan on the one side and US on the other in the medium term (see chart 12.4). The difference between the two has grown to the highest level since 2013. Hence, if anything one could expect the PPP-driven appreciation trend in EUR and JPY to pick up pace. Note further that we expect the oil price to range-trade short term (see *Theme #2*); all things equal that's JPY neutral.

Stuck below zero

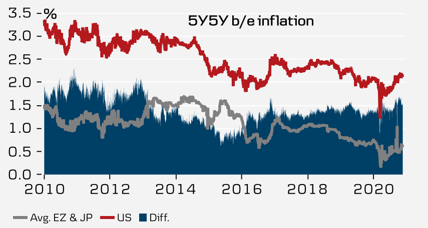
An important reason for ECB and Bank of Japan's inflation creation struggles is the challenge of the effective lower bound on policy rates. As we wrote about in our *FX Top Trades publication*, 4 December 2018, demography plays an important role in explaining, why the two central banks remain stuck below zero. The populations in the euro area and Japan are ageing and thus save a lot and are older than in China, the US and the UK (see chart 12.2). That keeps rates relatively lower. Further, we think we will likely witness a peak in the Chinese cycle in H1 (*Theme #5*), which will dampen an otherwise strong global recovery and recent CNH appreciation with it. Ideally, we would go long the trade-weighted EUR and JPY as we look for broad-based appreciation. However, to simplify matters we use a basket of CNH, USD, GBP and SEK which covers around 75% of the trade-weighted EUR (adjusted for JPY) and 50% of trade-weighted JPY (adjusted for EUR). Key risks to this trade include a structural shift where global reflation grabs hold and EUR and JPY net savings decline. Also periods of significant and rapid USD strength would hit the basket as illustrated by chart 12.1.

Chart 12.3: JPY and EUR have outperformed rest of G10



Past performance is not a reliable indicator of future results. Source: Macrobond Danske Bank

Chart 12.4: Market expects low EUR and JPY inflation to continue



Past performance is not a reliable indicator of future results. Source: Macrobond Danske Bank

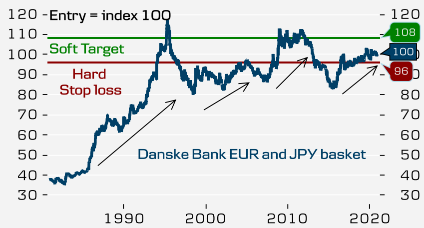
Trade #7. Long EUR and JPY vs CNH, USD, GBP and SEK

Long EUR and JPY vs basket spot (equal weighted)

Entry date	2 December 2020
Target (soft)	108.00
Stop-loss (hard)	96.00
Spot refs:	Index = 100 based on EUR/CNH: 7.9090 EUR/USD: 1.2059 EUR/GBP: 0.90482 EUR/SEK: 10.2897 JPY/CNH: 6.2663 JPY/USD: 0.9554 JPY/GBP: 0.7169 JPY/SEK: 8.1525

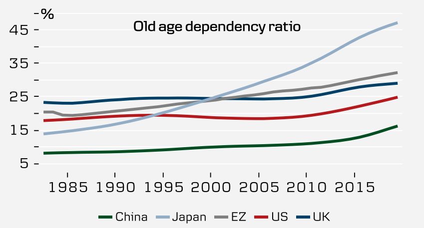
Source: Macrobond Financial, Danske Bank

Chart 12.1: EUR and JPY appreciates unless investors rush into US assets



Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial, Danske Bank

Chart 12.2: Buy currencies of old populations



Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial, Danske Bank

Trade #8. Long RUB spot basket

- **For RUB, we see sentiment as stretched negative (oil, economy, politics), whereas sentiment in HUF, TRY, ZAR alike is arguably stretched positive.**
- **High CPI on both sides of the trade mean we are not betting against a drift.**
- **The trade is partly hedged against an EM-blowout, less exposed to the USD cycle.**

Rouble: 2021 could add more tailwinds than 2020

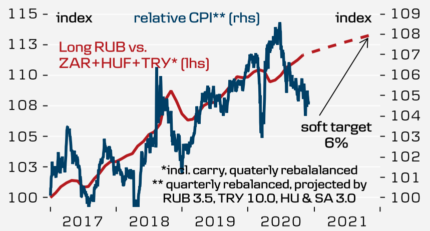
Since June, the RUB has fallen c.10% versus the USD. Rising investor aversion to the global energy sector (amid a boom in global renewables) and Russian geopolitics have been key factors (chart 13.1, 13.2). Inventory levels in the oil sector still have some way to go before they are normalised but positive news on the COVID-19 vaccine front has brightened the outlook and we expect the oil price to move towards USD60/bbl by the end of 2021. Russian inflation has shifted gear to the low 2-4% range and thus drift has come down relative to history. Rather, other cyclical factors have become important (cf. the above). As we see it, there is an asymmetric outcome space to be utilised as we see limited scope to price more negativity in oil and politics but a high possibility to take some of this out going in to 2021. We thus like to be long RUB versus peers as we move in to 2021.

Short HUF, TRY, ZAR: hedging by trading CPI peers in EM

However, being long RUB against e.g. USD is less straightforward as the cycle is likely still intact (*Theme #3*). Rather we prefer to buffer the low but still relevant CPI-based drift. We suggest being short HUF, TRY, ZAR, as these currencies appear tactically stretched. HUF (versus EUR) appears too strong, as markets believe the central bank will raise rates but with CPI at 3% we expect those calls to fade. TRY has strengthened on the back of a still-to-be-proven regime shift, but inflation will still offset the carry. Further, should we see a rising oil price, this would likely be TRY-negative by deteriorating terms of trade. Lastly, ZAR has strengthened primarily on the back of the recent boom in industrial and precious metals, but fundamentals remain weak. We expect the peak in a Chinese credit cycle to similarly also start marking a bottom in USD/ZAR over the coming months, on top of which we would not be surprised about downgrades or further rate cuts in South Africa.

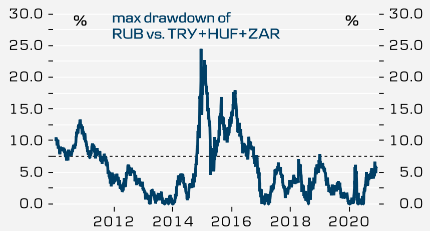
Jointly, funding a long RUB via TRY, ZAR, HUF means we have a small but positive CPI-based risk premium (chart 13.3) at a point in time, where the markets have become stretched negative on RUB, conversely too positive in our funding of choice. In addition, the basket has a more limited max drawdown of about 8% in normal times (chart 13.4). Risks to this trade include (1) further hikes by Turkey and notably (2) a continued outperformance of metals versus energy prices would likely propel a further divergence in RUB versus peers.

Chart 13.3: RUB vs CPI peers



It is not possible to invest directly in an index
Source: Macrobond Financial, Danske Bank

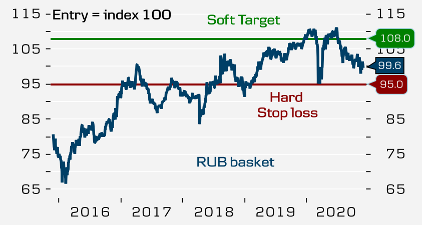
Chart 13.4: Drawdowns limited



Source: Macrobond Financial, Danske Bank

Trade #8. Long RUB

Long RUB vs TRY, HUF, ZAR spot	
Entry date	2 December 2020
Spot refs:	Index = 100 based on RUB/HUF: 3.916 RUB/TRY: 0.1035 RUB/ZAR: 0.2031
Target (soft)	112.00
Stop-loss (hard)	94.00

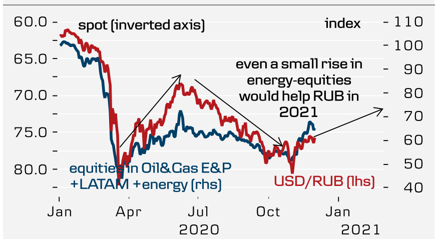


Source: Macrobond Financial, Danske Bank

Chart 13.1: RUB tactical drivers

It is not possible to invest directly in an index
Source: Macrobond Financial, Danske Bank

Chart 13.2: Small tailwind would be fine



It is not possible to invest directly in an index
Source: Macrobond Financial, Danske Bank

Disclosures

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