

## CitiFX NY Update

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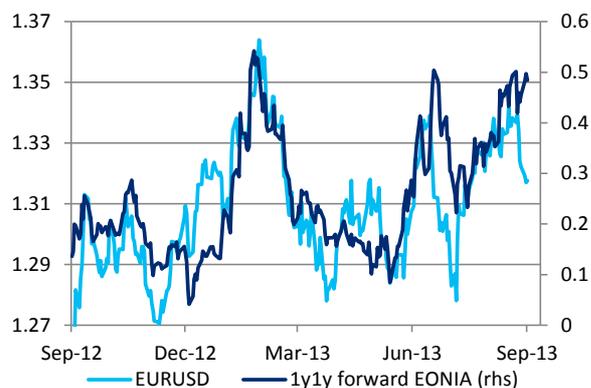
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### ECB preview – extended period of rate guidance

Ahead of the ECB meeting today, Citi economists think that the Governing Council could strengthen its forward guidance by extending the forecast horizon of their economic projections. This would be consistent with a recent piece by ECB's chief economist Peter Praet who argued that the bank's rate guidance reflected their expectation of inflation staying below target for an extended period of time.

A longer-term inflation forecast (potentially including 2016) that signals that CPI inflation is expected to remain below target (close to but below 2%) in coming years would represent a more concrete signal about the duration of the 'extended period. This could strengthen ECB's forward guidance to a degree. As regards the inflation projections for 2013 and 2014, Citi economists expect no significant changes in staff projections to the 1.3% annual inflation in 2014. In addition, President Draghi could indicate that the ECB continues to see only very slow recovery in the Eurozone with downside risks still in place. This could be supported by only slight adjustments of the growth projections for 2013 and 2014. Citi economists expect the staff forecasts to move from -0.6%YoY to -0.5%YoY for 2013 and from 1.1%YoY to 1.2%YoY for 2014.

**Figure 1. EURUSD vs. 1y1y forward EONIA**



Source: CitiFX, ONS

**Figure 2. EURUSD and EUR-USD rate spread**



Source: CitiFX, Bloomberg

We think that the ECB could also try to lean against the recent backup in euro short-term rates by signaling that more aggressive policy measures like rate cuts are still under consideration. Such signals in combination with more detailed forward guidance could usher a correction lower in the short-term euro rates and push EURUSD closer to the bottom of its recent 1.2800-1.3400 trading range. The price action could be similar to that in June when the ECB first announced its rate guidance (Figure 1). In addition, some downside risks for EURUSD could remain in place as we head into the all-important September Fed meeting provided there are no significant disappointments from the US labor market and sentiment data. This could lead to further tightening in the EUR-USD rate spread and weigh on the currency pair (Figure 2).

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Recent attempts by the Governing Council to guide European rates proved less successful. As a result, the EUR dips in the aftermath of the ECB meetings proved to be shallow and temporary. If the ECB fails to deliver a more aggressive rate guidance Eurozone short-term rates could extend their bounce while EURUSD could consolidate above recent lows with investors turning their attention to the upcoming US data and Fed policy meeting.

Valentin Marinov

## Laboring into NFP – keep buying USD/JPY

Three labor data points today feed into expectations for NFP tomorrow. We would discount ADP, put a fair amount of weight on ISM, and enjoy the trend in jobless claims. The trends should be positive, reinforcing a Fed tapering, UST sell off and USD-JPY buying.

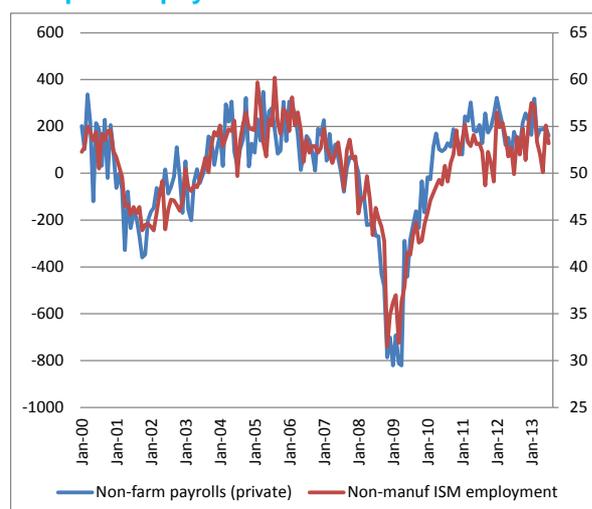
**You can't interpret ADP numbers.** Although ADP changes give the best explanation of Non-farm payrolls (statistically it can't be beat), the methodology is changed every few years, and more importantly, the back history is revised to give a strong fit. On paper, it looks the best, but as it's been revised that way – the forecasting power is highly questionable. 200k or above would surprise  $\frac{3}{4}$  of forecasters.

**ISM employment above 55, buy USD/JPY.** ISM (both manufacturing and non-manufacturing) capture broadly the same trends as ADP – without all the fuzziness of its history. In recent months the ISM employment figure has consistently been above 50 (pointing to mild growth), while generally underperforming the broader index.

Today our economists expect 55 for the headline number, in line with consensus but at the high end of the range since 2010. **An employment print of 55 or above should be watched for – it would break the range since March – and drive USD/JPY higher and USTs lower.**

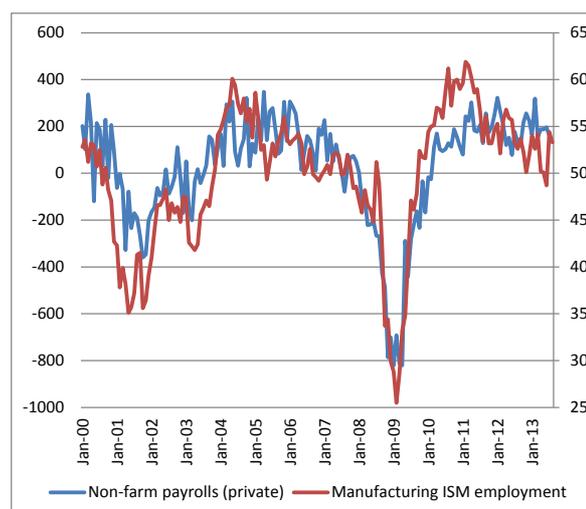
A print of 54 on the employment sub-series would imply a 200k private payroll print. Manufacturing ISM is already forecasting 190k for NFP.

**Figure 3. Non-manufacturing ISM employment and private payrolls**



Source: CitiFX, Bloomberg

**Figure 4. Manufacturing ISM employment and NFP**



Source: CitiFX, Bloomberg

**Initial claims matter for the trend.** Initial and continuing jobless claims probably are expected unchanged from their respective prior week prints (330k). These data will have no implications for the August employment report, as

they are both beyond the BLS' survey period. However, the Fed will pay attention to the trend, and so far the trend remains favorable.

*Richard Cochinos*

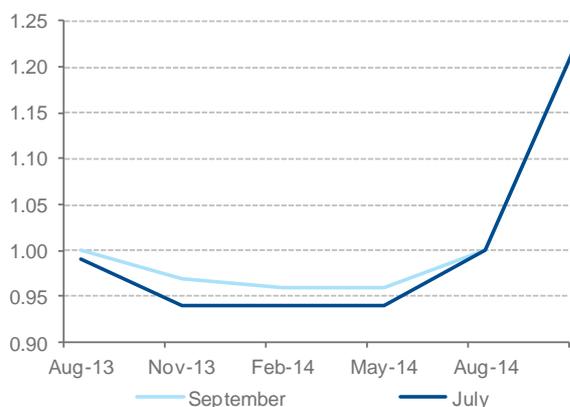
## Little changed post Riksbank

The Riksbank meeting brought few surprises, with the policy unchanged and Flodén/Ekholm continuing to favor further easing. The conditional rate path was marginally higher, but continued to indicate risks to the downside into the first half of 2014 (Figure 5,6), with a small probability of cuts. Market expectations that rate hikes could start as soon as April 2014 were misplaced and subsequently dialed back modestly. Nearer term, given the message leans on the slightly more dovish side of neutral, it should be supportive for NOKSEK, highlighting market expectations for monetary policy divergence as unlikely.

The Board recognizes the improved outlook but acknowledges a likely slow recovery. Indeed, Governor Ingves notes the weaker first half in Sweden doesn't change their outlook for growth ahead and that the Board was more convinced the worst is behind them. The inflation outlook was largely unchanged and growth forecasts were brought down to reflect the more sluggish first half. The broader picture seems little changed after today's communications. Over the coming weeks, SEK will likely be at the mercy of broader market developments interspersed with domestic activity data. In that regard, a dovish ECB later this afternoon could see EURSEK give back recent gains.

*Josh O'Byrne*

**Figure 5. Riksbank Conditional rate path July vs. September**



Source: CitiFX, Bloomberg

**Figure 6. Changes to Riksbank rate path and growth forecasts**

	September	July
Aug-13	1.00	0.99
Nov-13	<b>0.97</b>	0.94
Feb-14	<b>0.96</b>	0.94
May-14	<b>0.96</b>	0.94
Aug-14	1.00	1.00
Nov-14	1.25	1.25
GDP-2013	<b>1.20</b>	1.50
GDP-2014	<b>2.70</b>	2.80

Source: CitiFX, Bloomberg

## Kuroda's support for the tax hike likely depreciate JPY

The BoJ left its policy unchanged today as broadly expected. But, at the regular press conference, Kuroda expressed his willingness again to decide an additional easing if the economy unexpectedly slows down after the sales tax hike scheduled next April. He also emphasized the importance of the fiscal consolidation. Virtually he urged the government to implement the planned tax hike.

Our economists in Citi Tokyo expect the economic growth rate would decelerate to 0.4% in FY2014 without any fiscal stimulus package. Even in the case to suppose the supplementary budget to be organized after the tax hike, they calculate the growth rate could be 1.0% or something at most. This effectively means the additional monetary

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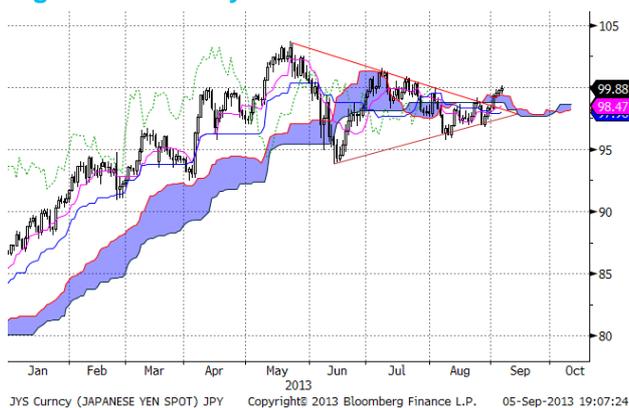
easing by the BoJ is highly likely next year. This view of us has been confirmed by the recent comments from Governor Kuroda.

Against this backdrop, a possibility of the restart of the JPY depreciation appears to be increasing. Of course, it won't be easy for USDJPY to breach above the 100 level, where most of Japanese exporters virtually target to hedge their USD exposures. However, so far we haven't seen any strong selling pressure from them even though USDJPY is coming up above this crucial level today. Not a few Japanese exporters are said to have decided to keep the forward hedging ratio at unusually low level, expecting the JPY weakness likely to continue over the long term. Essentially this looks a risky gamble, but the USD selling pressure indeed remains weak at this moment.

In fact, USDJPY has lately breached up above the resistance line from the high in May this week (Figure1). There will be no strong resistance before the high in July at 101.5 in the short-run. Also, we expect the upside target could be extended to the high in May at 103.7 within a couple of months, if the Fed decides at the FOMC meeting this month to begin cautious tapering and both US equities and interest rates continue to rise moderately. Interestingly, despite the recent increase in UST yields, the JGB yields remain well contracted these days (Figure2). Eventually, the Kuroda BoJ's bazooka easing seems to start to influence positively in JGB market, which could affect the Japanese currency negatively in the foreign exchange market.

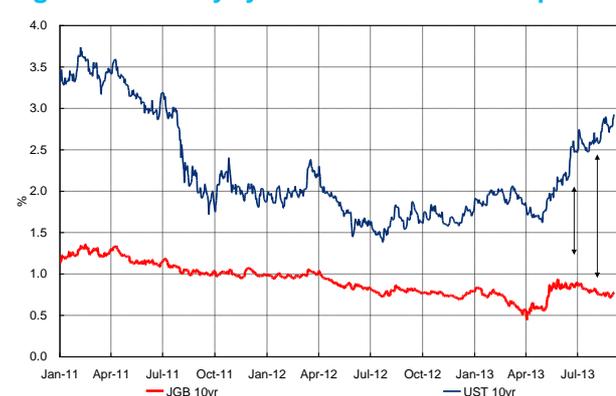
Osamu Takashima

Figure 7. The daily Ichimoku chart for USDJPY



Source: CitiFX, Bloomberg

Figure 8. The 10yr yields in the US and Japan



Source: CitiFX, Bloomberg

## Why the Fed is feeling good about tapering...

... and why the USD will benefit.

Remember the concerns about financial market froth – one manifestation is shown in Figure 7. The S&P dividend aristocrats ran up 25% from the time the QE3 buzz developed in mid-August 2012, outperforming the overall S&P by 6.5 percentage points, and the NASDAQ by 9.5%. All data are normalized to August 15 2013 = 100.

Now consider Figure 8 which normalizes to May 20 2013 = 100, just before the Bernanke comment that opened the tapering door. NASDAQ is up by 4.3%, the S&P is essentially flat (down by 0.7%) and the S&P dividend aristocrats are down by 2.2%. Whereas QE3 in its heyday bid up anything that had a coupon, the prospect of tapering has not done any damage to the NASDAQ's growth/tech stocks and has cooled investor enthusiasm for coupons for the sake of coupons.

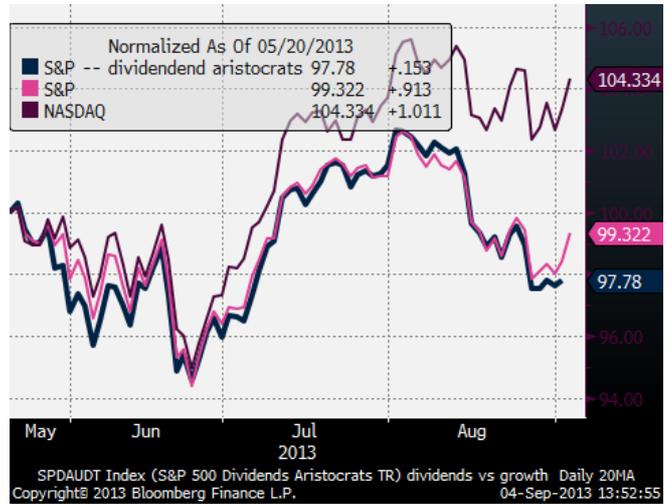
So from a Fed perspective, the damage done by tapering to equities has largely been to bond-like stocks, which were not the intended beneficiaries of QE3, while growth/tech stock have done very well. That is probably better performance than they would have expected given the backing up of yields.

**Figure 7. Which equities benefited from QE3?**



Source: CitiFX, Bloomberg

**Figure 8. Which equities benefited from tapering?**



Source: CitiFX, Bloomberg

Now consider the performance of US versus foreign equity markets (Figure 9). NADAQ has greatly outperformed the Euro STOXX (green), Nikkei (light blue), and EM local currency MSCI (grey). Even the overall S&P (pink) has outperformed the other indices. Nikkei underperformance is mitigated by about 3% if it is measured in USD but still is underperforming. So net net, we have US equity market robustness, in a sharply rising rate environment and outperformance relative to other major equity markets.

The sharp backing up of US rates has led to some position cutting, but it is likely that US 10 yr Treasuries with a 3-handle to yield will be more attractive relative to other bonds than they were with a 1-handle, once the dust settles.

**Figure 9. US equities continue to outperform**



Source: CitiFX, Bloomberg

Net, net, tapering has enhanced the relative attractiveness of US asset markets. To be sure, it has enhanced US asset market attractiveness by clobbering many asset markets abroad but Fed officials are pretty clear that they are making policy for the US, not the G20.

Steven Englander

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## Subtle tightening in Beige Book wage language

The September Beige Book reaffirmed limited-to-modest wage growth. However, when we compare the excerpts below, it looks like there is a slight toughening in the language on wages. There is nothing suggesting hyperinflation but for the first time in a long time we are beginning to see commentary on labor shortages in selected fields translating into wage pressures.

### July 17 – Beige Book

Most Districts reported that wage pressures remained limited or contained. **The Chicago and Minneapolis Districts reported moderate wage pressures.** The Chicago District noted that rising healthcare and other benefit costs were being passed onto employees. **Contacts in the New York and San Francisco Districts noted that competition for technology workers had an effect on salaries.** **The Richmond District noted that wage growth picked up in the manufacturing sector,** remained robust at non-retail establishments, and flattened at retail businesses.

### September 4 - Beige Book

Wage pressures remained modest overall. The Boston, Philadelphia, Cleveland, Atlanta, Dallas, and San Francisco Districts reported that wage pressures were largely subdued. Cleveland and Dallas highlighted that, overall, wage pressures at homebuilding and other construction-related firms were contained. **New York reported that some firms have become increasingly willing to negotiate salaries,** although pay rates have not escalated significantly. **Reports from a few Districts highlighted significant labor supply constraints and, in some cases, large compensation increases for workers with specialized skills in selected sectors,** including the construction and high-technology sectors in Atlanta and Kansas City and the engineering sector in Dallas. **Kansas City also reported that some firms in the retail, leisure, and hospitality industries were beginning to raise wages to attract salespeople,** housekeepers, maintenance staff, and clerical staff. Increases in the costs of employee health benefits continued to put upward pressure on overall compensation costs, although Minneapolis indicated that growth in the price of health-care has slowed.

*Bryan Zarnett, Steven Englander*

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