Research Reports

Currency Strategy

September 2020

Contents

FX forecasts

	14 sep	3M	6M	12M	Q4 21	Fwd 12M	Consensus* 6M	SEB vs consensus
EUR/USD	*1.19*	1.18	1.19	1.24	1.24	1.20	1.20	-0.8%
EUR/JPY	*126*	123	123	125	124	126	126	-2.8%
EUR/GBP	*0.92*	0.89	0.86	0.84	0.82	0.93	0.91	-5.3%
EUR/CHF	*1.08*	1.08	1.09	1.11	1.12	1.07	1.09	0.0%
EUR/SEK	*10.42*	10.33	10.14	9.92	9.85	10.46	10.28	-1.4%
EUR/NOK	*10.69*	10.72	10.50	10.22	10.20	10.77	10.40	1.0%
USD/SEK	*8.77*	8.75	8.52	8.00	7.94	8.73	8.57	-0.5%
USD/NOK	*8.99*	9.08	8.82	8.24	8.23	8.98	8.67	1.8%
GBP/USD	*1.29*	1.32	1.38	1.47	1.51	1.29	1.32	4.4%
USD/CAD	*1.32*	1.34	1.33	1.30	1.29	1.32	1.31	1.5%
USD/CHF	*0.91*	0.92	0.92	0.90	0.90	0.90	0.91	0.8%
AUD/USD	*0.73*	0.75	0.76	0.77	0.78	0.73	0.73	4.0%
NZD/USD	*0.67*	0.67	0.67	0.66	0.66	0.67	0.67	0.0%
USD/JPY	*106*	104	103	101	100	105	105	-1.9%
GBP/SEK	*11.31*	11.56	11.76	11.76	11.99	11.28	11.31	3.9%
JPY/SEK	*8.28*	8.42	8.27	7.92	7.94	8.29	8.16	1.4%
CHF/SEK	*9.67*	9.56	9.30	8.94	8.79	9.73	9.43	-1.4%
NOK/SEK	*0.97*	0.96	0.97	0.97	0.97	0.97	0.99	-2.3%
EUR/DKK	*7.44*	7.45	7.45	7.45	7.46	7.43	7.46	-0.1%
EUR/PLN	*4.45*	4.38	4.32	4.21	4.17	4.48	4.38	-1.4%
USD/CNY	*6.81*	6.89	6.86	6.80	6.78	6.98	6.85	0.1%
USD/RUB	*75.3*	73.2	72.2	71.8	73.5	78.3	72.0	0.3%
USD/TRY	*7.49*	7.62	7.73	8.06	8.40	8.75	7.60	1.7%

**Bloomberg survey FX forecasts.*

How to trade it

We believe that the USD will continue to weaken in the medium term, but there is likely to be a bump in the road. The US presidential election, dollar positive seasonality, heavy USD short positioning and slowing recovery in Q4 may all support the dollar during coming months. This provides an opportunity to benefit of the stronger dollar against the euro, before the euro strength continues next year. We also find Swedish krona as attractive vs. the euro and the yen is likely to gain vs. the dollar going into next year.

EUR/USD: Buy 1.18/1.16 put spread at EUR 0.6%. Despite our constructive view on the EUR/USD in the medium-term, we believe there is a good chance that risky assets experience a setback during Q4, pressing EUR/USD temporarily lower (see EUR/USD article on page 10). The seasonally dollar positive November, the US election and a large long EUR/short USD positioning support the case. For EUR based corporates and asset managers hedging their dollar exposure, we continue to recommend to keep hedging ratios relatively high, although those more opportunistic FX managers that share our view of the short term downside risks could consider reducing the hedging ratio a notch. The implied 25 delta call volatilities are trading some 0.5 vol above ATM in both 3- and 6-month tenors, while the 25 delta put vols trade close to the ATM levels. The smile is not high enough for us to consider zero cost seagull upside hedges as an attractive substitute for the forward hedges in the 3-month period. Those willing to pay up a bit for a wider seagull structure could consider buying 1.16/1.1890 ATMF/1.23 at EUR 0.45% instead of a forward hedge (spot ref. 1.1865). For speculative accounts looking to benefit from a temporary sell-off, we see buying 3m 1.18/1.16 put spreads at EUR 0.6% (spot ref. 1.1865) as attractive.

USD/CAD: Sell on rallies towards 1.35. As discussed above, we see risks that the dollar may gain during Q4 for several reasons. This should be USD/CAD positive due to the pair´s high sensitivity to risk appetite and oil. However, the Canadian dollar is the only G10 currency that investors are not particularly long vs. the dollar, which could give some extra support for the pair to move lower next year as the global recovery gains pace again. In short, we expect the USD/CAD to rally towards the 1.35 level during the coming months, which should be seen as an opportunity to build shorts.

EUR/SEK: Stick to a short position for levels below 10 in 2021. The krona has climbed faster this year than we previously expected. Behind this krona appreciation are several factors that are now pulling in the same direction: higher risk appetite and rising share prices; the krona's attractive valuation; positioning, with market players having probably been underweighted in the krona over the past couple of years; narrowing interest rate differentials between Sweden and other countries; and the milder negative impact of the COVID-19 crisis on Swedish growth compared with similar economies. In recent weeks we have seen the SEK consolidate but given its low valuation we expect it to continue to recover in coming months a target 10.00 early next year.

Sell USD/JPY, target 100. The JPY was one of the prime beneficiaries as the COVID-19 crisis hit markets. USD/JPY plunged from 112 to 102 in the matter of a few days. Since then however, the cross recovered very quickly as risk appetite returned with a vengeance and the normally defensive JPY gave back ground. But the Fed and the ECB are running substantially more expansive monetary policy vis a vis the BOJ. Although the current account has deteriorated, Japan remains a creditor with a strong net international investment position. The JPY is undervalued and is likely to gain as the rest of the world is now pushing their interest rates towards Japanese levels. The pair has posted constantly lower highs during the past years and the 105 level has held up well. We believe the pair will break lower soon and we target 100 in USD/JPY at the end of next year.

While exchange rates seemed to have detached completely from currency specific factors prior to the pandemic, this now appears to have changed significantly. Since the pandemic the relative performance of G10 currencies suggests that there are now two important drivers for exchange rates; changes in the global risk sentiment and the fact that differences in interest rates among G10 currencies have become significantly smaller. What is currently going on in the FX market is probably just a process of adapting to these new conditions. In a scenario where the global economy continues to stabilise, we expect more of the same.

What is cooking in the market? Given the sort of questions we receive internally and externally from clients and journalists, there are couple of themes that clearly are in focus:

- On the back of the falling dollar, with the EUR/USD touching 1.20 briefly a while ago, there is naturally a lot of focus on the outlook for the USD. Will it continue to weaken? What could trigger a recovery? How will the presidential election affect the USD, will it matter who wins? More recently we have also observed a growing interest in the euro, which is simply the flipside of the USD story; is there a line in the sand for the ECB?

- The second global theme which has attracted a lot of interest in recent weeks is the Brexit situation. What is the likelihood that there will be a trade deal in place by the end of this year and what will happen to the GBP and the EUR in case there is one or if they fail?

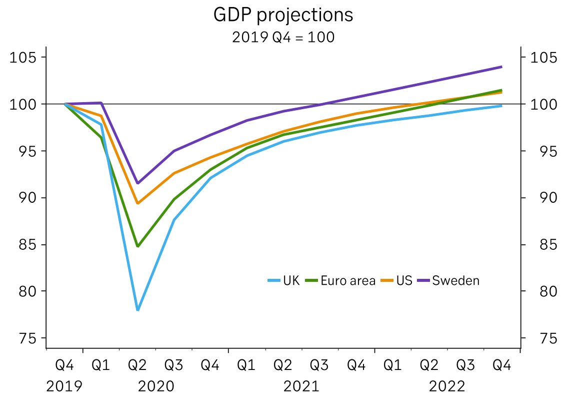
- From a Scandie perspective we also receive a lot of questions related to the recovery of the SEK. While it seems like the SEK recovery is not that surprising any more, questions are generally related to the potential consequences for monetary policy, or simply, how much further will the Riksbank allow it to go and what is the likelihood it will cut the key rate into negative again?

- Another frequent question we receive is why the NOK does not recover faster despite the huge positive net capital inflow created by the Norwegian central bank, and who is the seller?

While we try to provide answers to most of these questions in this report the last one is still a conundrum.

The global economy: Strong recovery but uncertainties persist. After a devastating Q2 with growth falling sharply from the previous quarter as economies were locked-down, the global economy has recovered remarkably fast during summer. Driven by support from ultralow rates and extensive central bank asset purchases, and government support programs like there is no tomorrow, risk appetite has returned on a broad scale in financial markets. In the real economy PMIs from the manufacturing sector and the service sector have generally returned to above the 50-level after the sharp falls during spring. This improvement has also been followed by recovery in production, household spending and employment.

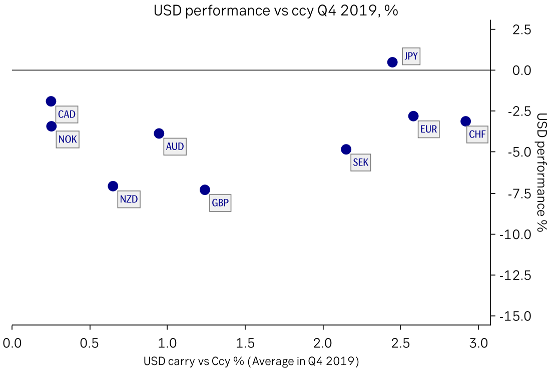
The question we ask ourselves right now is whether this is a sustainable recovery from a real improvement in demand or whether it is just the consequence of pent up demand and support programs. Clearly growth numbers will reach record levels in the coming quarters as the economies normalise. However, it seems like it will still take a long time before the damage from the lockdown this spring will be fully repaired, and the global economy is back to where it was by the end of last year.



This suggests a couple of things – capacity will be far from fully utilised, unemployment is likely to remain at a higher rate than before, inflation pressures should remain muted, interest rates should remain very low, and economies probably need further support from fiscal and monetary policy. Finally, the risk has definitely increased that the equity market correction in recent days may continue if it reflects the fact that growth and earnings might be lower than previously expected and isn't just a technical correction.

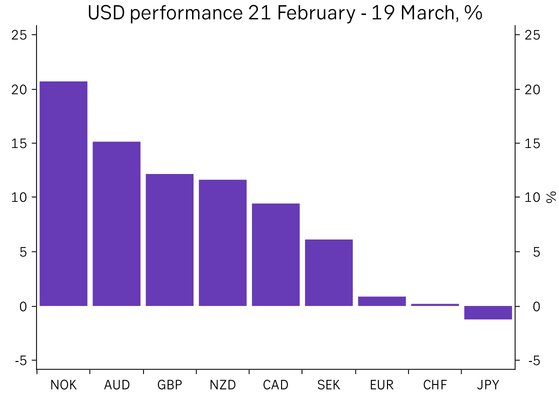
Is FX performance just about risk appetite? In previous reports and in particular prior to the COVID-19 outbreak, we discussed in length the fact that currencies appeared to have detached completely from their normal drivers like rate differentials and monetary policy expectations. The chart illustrates the complete breakdown in the traditional relationship between 3M carry and the relative performance of the USD against different G10-currencies in the last quarter of 2019. In fact, the situation was quite similar for most of 2019. The relative 3M rate had very little to do with the performance. For instance, the 3M rate for the USD was higher than for all other currencies in Q4 last year while the USD underperformed all G10-currencies except the JPY. Among the other currencies there is little to suggest the 3M rate would have had a material impact on the performance.

USD performance vs G10 and 3M carry, Q4 2019



Instead, pretty much all the volatility in the G10 exchange rates was then related to common global factors like the outlook for global growth, political risks and the general market risk sentiment. These had very little to do with individual currencies although currencies of course reacted differently on changes in risk appetite. It was also quite clear that during the outbreak of the pandemic the traditional correlations with risk appetite dominated the performance for currencies, where defensive currencies like the USD, JPY, CHF and the EUR outperformed smaller and less liquid currencies. Similarly, those currencies being most badly hit during the height of the pandemic were also recovering the most when risk appetite returned following the swift policy responses by central banks and governments.

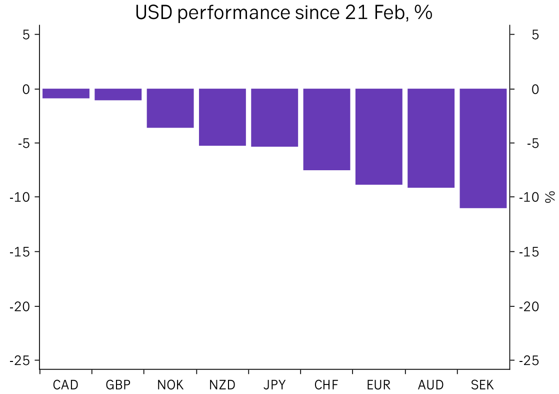
USD performance 21 February - 19 March, %



Last year we argued that this behaviour may arise as the normal currency drivers like central bank policy or rate differentials were quite stable and differences between currencies were generally small, while the business cycle was highly synchronised across the world. In other words, there were simply few reasons to expect any relative changes in these typical drivers for exchange rates for the foreseeable future. In fact, there were few reasons other than changes in the general risk sentiment why currencies should move at all. This was also reflected in measures of the volatility for G10 currencies like the 3M implicit volatility based on FX option pricing, which hit an all-time low in late January this year. A few weeks later it moved sharply higher as markets fell apart when the COVID-19 virus spread across the world.

However, during summer the COVID-19 situation has stabilised and countries have eased restrictions while risk appetite, as reflected by the global equity market performance, has been improving tremendously. Against this backdrop it seems like drivers for currencies have shifted over summer. The performances are no longer just about what happens to general risk appetite, although it probably still contributes. If we instead consider the performance of all G10-currencies against the USD since 21 February, i.e. the day before the market turmoil from the COVID-19 outbreak, there are a couple of interesting observations.

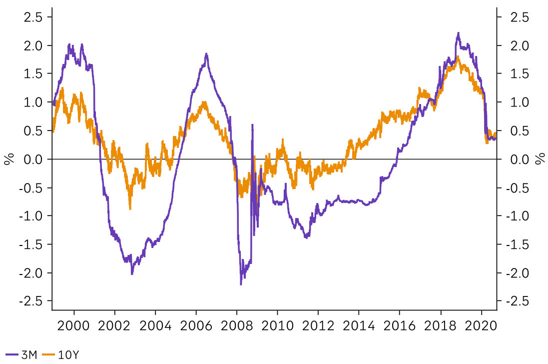
USD performance since 21 Feb, %



Since then the USD has weakened against all G10-currencies by between 1% and 10%. This is clearly in line with what we would expect should happen in a situation where risk appetite dominates. However, in contrast other currencies with traditionally defensive qualities like the JPY and the CHF have outperformed the USD this year, while the CAD has underperformed against all other currencies than the USD, which is not a typical situation for the normally procyclical CAD. Hence, this suggests that improving risk appetite probably remains one of the drivers for currencies, but it is not the only explanation to what is going on.

No! There is more to the story. One consequence of the swift response from central banks earlier this year is that almost all of them today have ended up with policy rates at or close to 0%. This is a different situation compared with before the COVID-19 outbreak. For some of the central banks, like the Fed, this has caused significantly lower short-term interest rates. Moreover, almost all of them, with one or two exceptions, indicate that rates will remain at the current level or lower for several more years before they will begin to tighten policy. Together with significant purchases of government bonds this has had a significant downward pressure on longer dated bond yields as well. Altogether this has reduced differences in interest rates between the G10-currencies across the curve.

3M and 10Y rate differential between US and G10 (Average)



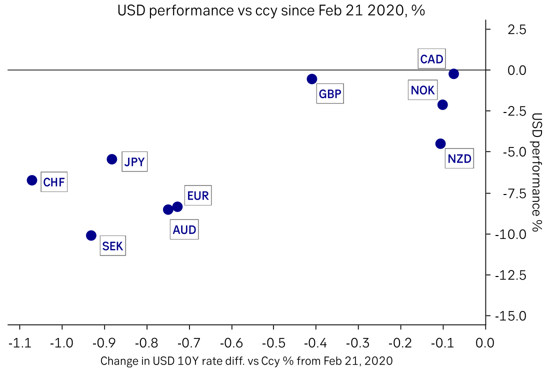
Traditionally, interest rate differentials and changes in interest rate differentials have usually been very important for the currency performance. The reason is that changes in the relative costs of hedging for businesses and financial institutions and the return on bond investments can cause large capital flows. However, in recent years there are several examples of exchange rates that have detached more or less from interest rates differentials.

In recent months this seems to have changed on the back of the COVID-19 response by central banks. One could argue that with rate differentials being this tiny these should be irrelevant for exchange rates and this might in fact be where we eventually end up. However, going from a situation with much wider rate differentials in just a few months has changed conditions for hedging, speculation and the view of exposures in different currencies structurally. We believe market players in the FX market are probably collectively adapting to this new situation, which seems to be sustained.

Although we can't claim that it is statistically significant, we simply plotted the USD's performance against the changes in the 10Y rate differentials between US rates and all other G10 currencies. To avoid distortion related to the COVID-19 turbulence in March, we have focused on the performance since 21 February, i.e. the day before the COVID-19 outbreak started to rock global financial markets. This kind of simple study suggest that although the USD has depreciated more or less against all currencies since before the COVID-19 crisis, currencies which have seen their 10Y rates moving the most against USD-rates have also outperformed the USD and other currencies. Meanwhile currencies where interest rates were closer to US interest rates, which subsequently have changed less, have not at all outperformed the USD in the same way. The outcome is more or less the same if the 10Y rates are replaced by 3M rates. Clearly these findings illustrate the importance for exchange rates of the huge shift which has occurred in relative interest rates since the beginning of the year, in both ends of the yield curve.

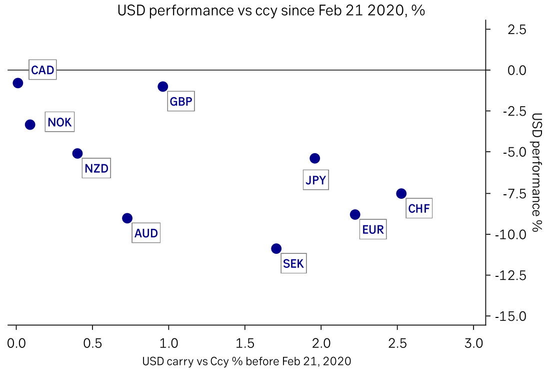
USD performance and change in 10Y rate diff.

USD performance vs ccy since Feb 21 2020, %



USD performance and carry

USD performance vs ccy since Feb 21 2020, %



Replacing relative interest rates with other currency drivers like the deviation from the long-term valuation against the USD for example shows no similar pattern, suggesting valuation is currently not that important for the currency performance.

The FX market is not done yet. While exchange rates seemed to have detached completely from currency specific factors prior to the pandemic and instead mostly moved in line with changes in global growth and the risk sentiment, this now appears to have changed significantly. Since the pandemic the relative performance of G10-currencies suggests there are now two important drivers for exchange rates; changes in the global risk sentiment (around the outbreak in spring and as the situation stabilised) and the fact that differences in interest rates among G10 currencies have become significantly smaller than before.

Currencies previously gaining from higher interest rates than the average G10 rate saw this support rapidly disappear reducing the attractiveness of them, while currencies previously facing headwinds from lower than average interest rates have suddenly attracted buyers. The FX market is probably in a process of adapting to these new conditions as market players rebalance their exposures and reconsider hedges etc. It will probably continue for a while longer before the situation settles. In a scenario where the global economy continues to stabilise in the coming quarters, we expect more of the same.

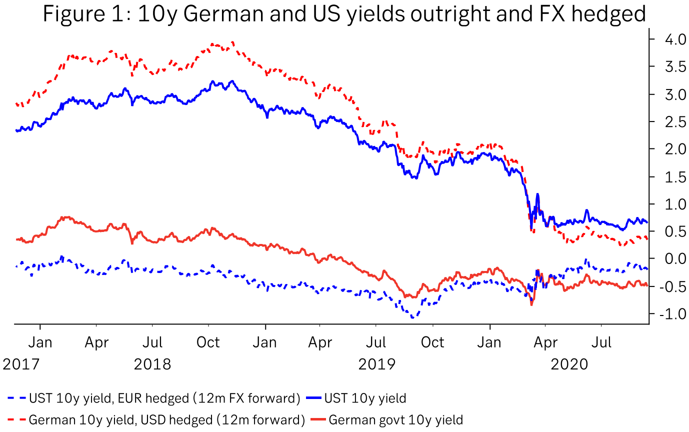
Currencies

EUR/USD

Slowing recovery may cap further gains in Q4

Euro has been strengthening on the back of the EU's joint fiscal support and the improved carry versus the dollar. However, we think that the recovery beyond the strong Q3 rebound is likely to be weak and the US election may limit risk-taking during the coming months. The euro is therefore unlikely to continue its strong rally in the short-term, but the outlook for the next year is brighter. The fiscal spending and public investments in Europe are likely to attract capital and continue to support the euro.

Figure 1: 10y German and US yields outright and FX hedged



Source: Macrobond, Bloomberg, SEB

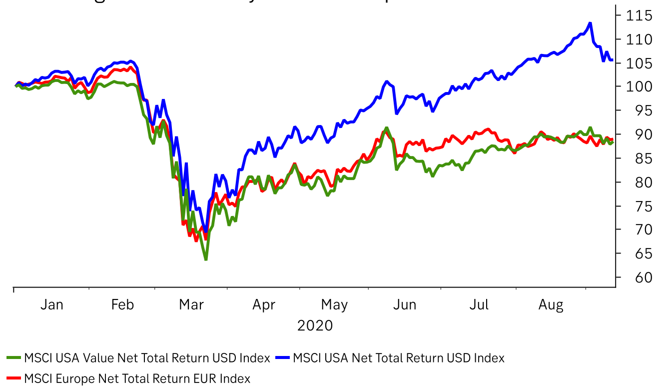
	14 sep	3M	6M	12M	Q4 21	LTFV*
EUR/USD	*1.19*	1.18	1.19	1.24	1.24	1.22
EUR/SEK	*10.42*	10.33	10.14	9.92	9.85	9.50
EUR/NOK	*10.70*	10.72	10.50	10.22	10.20	9.64
USD/SEK	*8.77*	8.75	8.52	8.00	7.94	7.76
USD/NOK	*9.01*	9.08	8.82	8.24	8.23	7.88
ECB	*0.00*	0.00	0.00	0.00	0.00	
Fed funds	*0.25*	0.25	0.25	0.25	0.25	

*Based on the SEB LTFV model

European fiscal outlook and improved carry behind the stronger euro. Many of the themes discussed in the previous edition of Currency Strategy in June are still intact. The Fed rate cuts earlier this year eliminated almost fully the negative carry for the EUR/USD, reducing considerably the incentive to buy dollars in the spot space. While the US investors have probably kept their euro hedging ratios unchanged or reduced them (euro positive), the euro area investors have likely increased their dollar hedging ratios after the Fed rate cuts, leading to increasing demand for euros in the spot space. Another important theme during the past months has been the relative fiscal response to the pandemic. Earlier in the year the US was clearly ahead of Europe in terms of fiscal support for households and companies. The Federal response in the US was rapid, while there was no credible mechanism for a coordinated action in Europe and the member states acted individually. The EUR 750bn Next Generation EU pandemic package and the EUR 1.1trn long-term EU budget in July changed the picture not only regarding the fiscal support for the current crisis, but the European Union's ability to respond to a crisis in the future. Moreover, Germany especially has introduced a notable fiscal spending plan for the coming years. The 2021-2022 public spending outlook for many individual European countries is likely to improve further as the ECB and the EU Commission both encourage bold deficit spending. The notable difference between the US and European fiscal response is that while the bulk of the support in both economies go to support the cash strapped companies and households, Europe seems to have more ambitious public investment plans for years to come which could turn out to lift potential growth. A win for Biden could, however, pave the way for a similar infrastructure push in the US. The improved growth outlook (in both sides of the Atlantic) together with the absence of a large negative carry have most likely been the main reasons behind the stronger euro during the past months, in line with our reasoning in June.

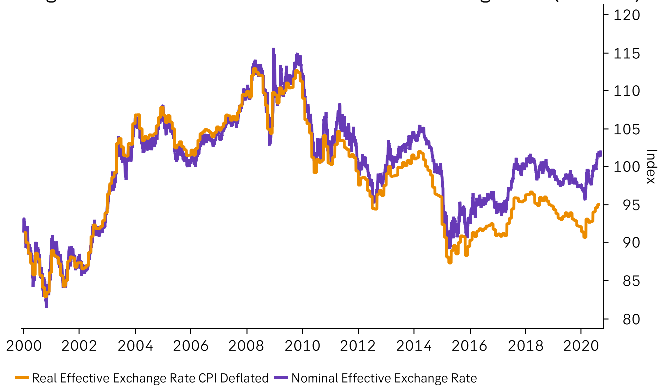
Recovery may falter in Q4, leading markets to discount further ECB easing. The rebound in economic activity in Q3 has been strong and to a large extent expected given the removed lockdown measures introduced earlier in the year. The strict social distancing measures, especially in Europe, resulted in a lot of pent-up demand in Q2 which has been released in Q3, leading to a very rapid V-shaped recovery. The mechanical rebound we are experiencing now tells us very little how the recovery will unfold beyond Q3. The COVID-19 pandemic continues to have a negative effect on peoples' behaviour and production as long as a vaccine is not widely available and mobility restrictions remain in place. This, together with increasing COVID-19 infections, creates a lot of uncertainty regarding recovery in Q4. The recovery gets fully going only when the household savings rate starts falling and the companies start hiring on a large scale. If COVID-19 remains with us for the coming 3-6 months, it could badly hinder the recovery process if private spending gets stuck at low levels. If the recent rapidly improving economic data in Q3 starts to falter and the incoming data points to dismal growth for Q4, it is likely to result in a setback in risk assets. This would work in favour of the dollar and increase expectations of further ECB easing, e.g. rate cuts. It is good to bear in mind that unlike the Fed, the ECB has never shut the door for further rate cuts. Quite contrary, according to the bank, the negative rates have been beneficial. While further rate cuts are unlikely in our view, surprisingly soft data would lead markets to discount further policy easing from the ECB and weigh on the euro. The Fed has been more vocal about its dislike of negative rates. A large, long EUR/USD positioning among speculative accounts also adds to the downside risks (see the theme article Positioning).

Figure 2: Tech rally has left Europe and value behind



Source: Bloomberg, Macrobond, SEB

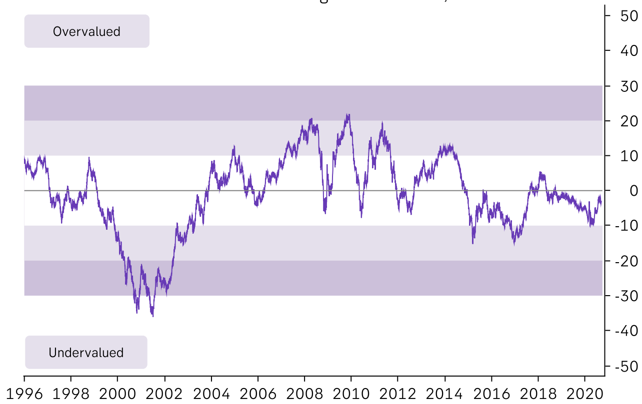
Figure 3. Euro nominal and real effective exchange rate (EER-19)



Source: ECB (European Central Bank), Macrobond, SEB

EUR/USD

Deviation from long-term fair value, %



The US election adds to the Q4 uncertainty mix. We believe that risky assets are likely to experience a temporary setback if Democrats win the election, mainly due to the simple reason that a change of government creates uncertainty. Democrats may be seen as less pro-business than Republicans and have promised to more than reverse the tax cuts and reintroduce the regulations that helped the equity market to rally during the past years. However, Biden may introduce some large public investment plans which could support growth in the US economy, mitigating the negative effect in the markets. If the Trump administration remains in office, it could spark renewed social unrest and further fuel the fears of trade tensions with China, which could shake markets as well. Increased uncertainty in the financial markets usually lead to less risk-taking and a stronger dollar. The race in key states is currently so even that it is impossible to forecast the outcome. Historically, the dollar has gained not necessarily after the election day, but after the inauguration. This has happened especially if a Democrat candidate has won its first term (read more here). Our main conclusion regarding the early November election outcome is that it will increase volatility temporarily and possibly erode risk appetite, especially in case of a prolonged wait for the final result, leading to the stronger dollar. The dollar should start to weaken again 1-2 months after inauguration in case Biden wins and somewhat earlier if Trump wins.

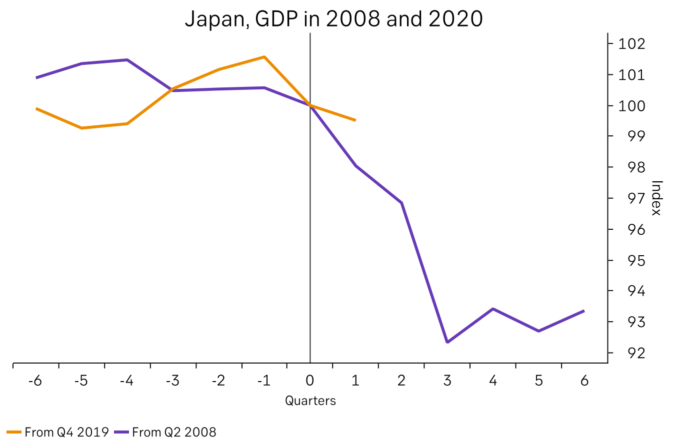
Capital flows should benefit the euro in 2021. Both we and Bloomberg consensus expect Eurozone growth to outpace the US next year. However, this is due to the fact that European countries implemented stricter lockdown measures in Q2 2020, leaving Eurozone GDP to fall more in 2020 and therefore the rebound is expected to be stronger in the following year. The growth difference itself may not be a big deal for the euro, but the fact that the Eurozone may be entering a more coordinated, area wide large fiscal spending era could attract capital. After a decade of very stagnant growth, investments and underperforming equity markets, the cheaper European equities could attract equity flows next year as the economies continue to normalise with the support from public spending. Normalising economies should benefit the cheaper cyclical stocks relative to the recently sky rocketing technology sector. Given that the US equity market has a considerable technology exposure (30% in MSCI US), while the European equities are more concentrated on the traditional cyclical industries (tech <10% in MSCI Europe), it is a very plausible scenario that cheaper European equities could attract capital flows next year at the expense of more expensive US equities (Figure 2).

Long-term valuation. When it comes to the recent discussion about the euro's strength and its impact on inflation, we are less convinced that the ECB has a cause for a concern. First, the euro has appreciated by only 2-3% against the major trading partners since June, when no one seemed to be concerned about the level of the currency (Figure 3.). Secondly, a large ECB study shows that the exchange rate impact on consumer prices is very small and not always even statistically different from zero. Both the nominal and real effective exchange rate indices are close to the historical average levels and by no means particularly strong. However, the market narrative seems to be that 1.20 has become some kind of trigger level for the ECB, which might curb investor appetite for building longs around those levels. Our estimate of the EUR/USD long-term equilibrium exchange rate has increased to 1.22, which is the highest level in almost five years. The higher long-term fair value is due to the decreasing real rate difference and faster increase in ULC and CPI inflation in the US. Altogether, our valuation approach suggests that the EUR/USD currently trades very close to the long-term fair value.

USD/JPY

Broad-based USD weakness lifts JPY

The JPY remains undervalued against the USD. Strong risk appetite is a negative for the currency, but as global rate differentials shrink and the greenback continues to depreciate we expect the JPY to gain – we target USD/JPY down towards 100.



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JPY/NOK	*8.51*	8.74	8.57	8.16	8.23	8.76
GBP/JPY	*136*	137	142	148	151	141
Fed funds	*0.25*	0.25	0.25	0.25	0.25	
BOJ	*-0.10*	-0.10	-0.10	-0.10	-0.10	

*Based on the SEB LTFV model

Defensive but less so vs the past

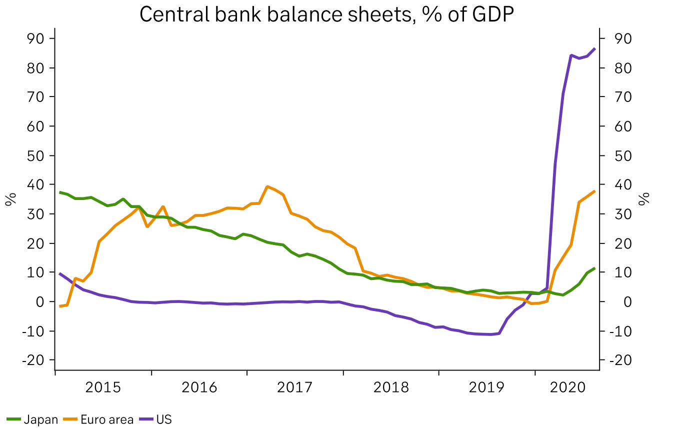
As is normal, the JPY showed great defensive characteristics when the Covid-19 outbreak scared financial markets from around mid-February. These defensive qualities are probably related to permanently low Japanese interest rates and repatriation flows as Japan has one of the largest net international investment positions, which again made it one of the strongest performing currencies during a global crisis. Strong risk appetite limits the upside for the defensive JPY, but FX drivers are also slowly changing and in the context of valuation and fundamentals, we expect the JPY to appreciate vs the USD. Risk appetite has also been taken to very lofty levels making the call for continued equity market upside less convincing.

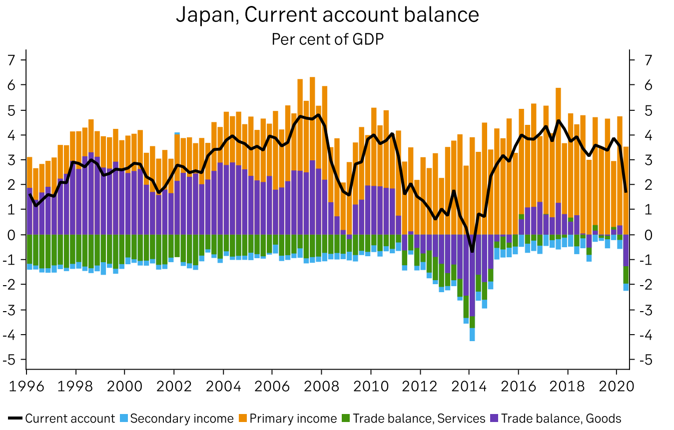
Falling GDP on par with the "best" European countries

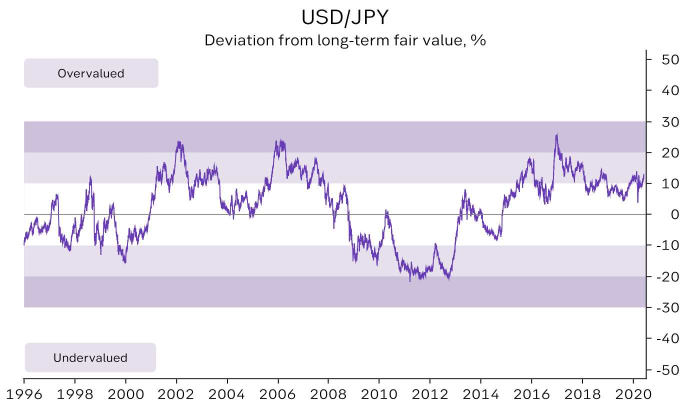
Japan's economy was weak even before the Covid-19 crisis started, and GDP declined by 1.8% q/q in Q4 after household spending had dropped sharply as a reaction to the increase of the consumption tax from 8% to 10% in October 2019. Although there were signs the economy had begun to recover early this year the outbreak of Covid-19 in February rapidly changed the situation for the worse again. In Q1 GDP declined by 0.9% from the final quarter of 2019 whilst Q2 GDP shrunk by another 7.6% q/q SA. The BOJ expects the economy (fiscal year 2020) to shrink by 5% before recovering in 2021 by 3.5%. Prices are expected to decline by 0.5% before rising in 2021 by 0.4%. The overall impression is that the Covid-19 crisis has hurt the Japanese economy less than most countries in Europe and in the US.

Large government deficit but balance sheet is strong

In April, the Japanese government announced emergency economic measures including various support for households and businesses like cash payments, easing of requirements for employment adjustment subsidies, tax and social security contribution deferrals and lending programmes, which will support private demand in the coming quarters. As GDP is contracting sharply in 2020 and some automatic stabilisers are kicking in, the budget deficit is likely to end up at around 7-9% of GDP in 2020. The gross government debt ratio was already 230% of GDP by the end of 2019 and may grow further this year to almost 240% of GDP, which is among the highest in the world. However, Japan has for a long time generated large current account surpluses and today the country has large net claims on the rest of the world of around 65% of GDP. This means that despite this enormous government debt the government can fund itself internally, which means that neither the Japanese position nor the JPY is that vulnerable.







BOJ is less aggressive than Fed or ECB

With the policy rate at -0.1% and yield curve control focused on holding the 10-year bond yield at 0%, the key features of BOJ monetary policy remain the same as they have been for many years. In addition to unlimited purchases of JGBs the BOJ will actively purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) for the time being. As for CP and corporate bonds, the Bank will conduct additional purchases until March 2021 with the objective of increasing holdings to around three times the amounts previously held. The monetary base has started to increase again as a result of the Covid-19 crisis but at the moment the pace of purchases is "only" increasing M1 by about 10% annualised. In this context, Japanese monetary policy is not that JPY-negative as it used to be (given that balance sheets of the Fed and the ECB are expanding at +50-75% annually).

C/A-composition turning less JPY-positive

The goods trade surplus in 2019 had been supported by a larger than expected decline in imports despite the weak exports. We had expected a recovery in trade in 2020, but following the Covid-19 outbreak this is uncertain today. In Q1 2020 the current account surplus deteriorated massively as exports plunged. Given Japan is close to the region first out of the Covid-19 crisis we would expect the trade deficit to soon post a small surplus again. However due to the structural shift in the composition of the current account surplus towards greater dependence on net investment income from massive trade surpluses provides less of a buffer to the yen in the future. The inclination of pension fund managers to recycle their dividend proceeds into investments overseas takes some of the yen's shine off.

Long-term valuation

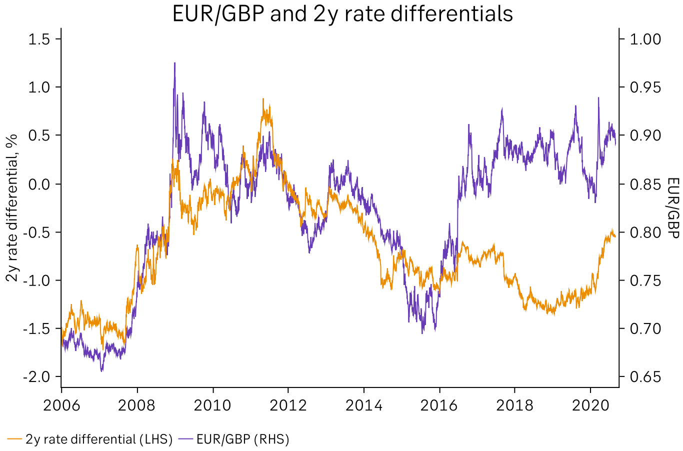
The JPY has been undervalued against the USD for several years since the JPY depreciated in 2013 and 2014. Long-term fair value according to our approach is below 100 in USD/JPY today. The widening difference between spot and fair value is partly related to the spot rate rising, but partly to lower fair value in the USD/JPY. Historically, it has not been unusual with the USD/JPY deviating by more than 20% from the fair value, which means today's deviation is not extreme. So long as the exchange rate is not exposed to any external shock it is reasonable with more of a sideways move going forward. In recent years the nominal ULC in Japan has increased, which has not been the case for a long time as the country has suffered from deflation. Deflation and falling nominal wages have always been supportive for Japanese competitiveness, which is why a stronger nominal JPY exchange rate over time is reasonable.

EUR/GBP

Hostage to a political game

Brexit and rising concerns that negotiations on a trade deal between the EU and the UK will fail has weakened the GBP in recent weeks. But honestly, is this a surprise? No, it is just the same situation as in negotiations on the withdrawal deal in 2018 and 2019. Back then it eventually ended up with an agreement and we bet this will be the outcome this time as well. The GBP will remain under pressure as long as uncertainty persists, but we expect to see it recover towards the end of the year.

EUR/GBP and 2y rate differentials



	14 sep	3M	6M	12M	Q4 21	LTFV*
EUR/GBP	*0.92*	0.89	0.86	0.84	0.82	0.78
GBP/USD	*1.29*	1.32	1.38	1.47	1.51	1.57
GBP/SEK	*11.28*	11.56	11.76	11.76	11.99	12.19
GBP/NOK	*11.59*	11.99	12.18	12.12	12.42	12.37
GBP/JPY	*136*	137	142	148	151	141
ECB	*0.00*	0.00	0.00	0.00	0.00	
BOE	*0.10*	0.10	0.10	0.10	0.10	

*Based on the SEB LTFV model

Risk of failing on a deal is keeping the GBP weak

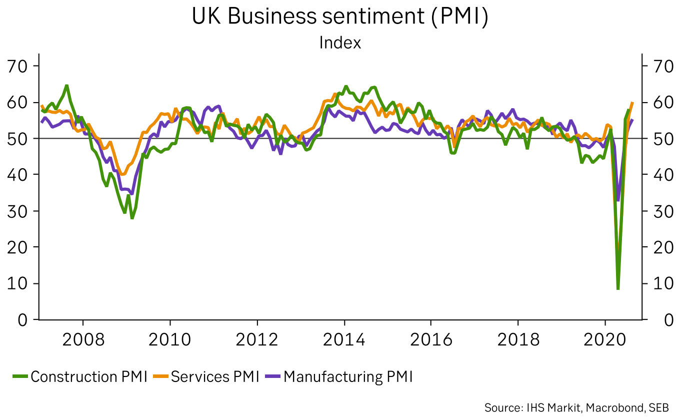
Since the beginning of 2016 the withdrawal process from the EU has been very important for the value of the GBP as it has moved with the likelihood of different outcomes. The risk of a hard Brexit i.e. that the UK would leav the EU completely by the end of this year without a trade deal in place forcing the former EU-member to trade goods and services with the EU based on WTO-terms is what frightens financial markets, particularly the FX market, and has kept the GBP weak. On 31 January the UK departed from the EU and moved into the transition period stretching until 31 December this year, which effectively leaves the UK a member state (but without political influence) for a couple of more months. So far negotiations have failed to bring EU and the UK together on comprehensive trade agreement, which will replace the withdrawal deal by the end of this year. The COVID-19 pandemic is partly to blame as it delayed negotiations significantly earlier this year.

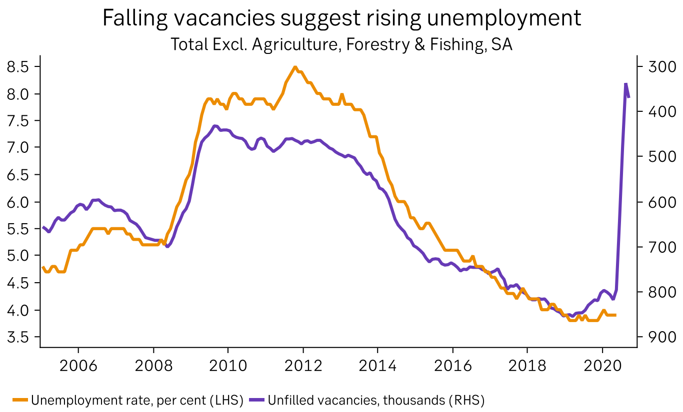
The Conservative UK government has taken tough positions against the EU and threatened to walk away from trade negotiations unless the UK was offered a reasonable deal. The EU has suggested a deal including "zero tariffs and zero quotas on all goods entering the single market", but it comes with conditions like common standards on environment, state aid, worker and consumer protection. This is usually what the EU refer to as a commitment to a "level playing field", which is tough for the UK government to accept. Other difficult areas are for instance fishing rights where the EU demands that the UK allows EU vessels to fish in its waters, and issues like the right for UK transporters to continue to operate within the EU in the future. Despite the promise to intensify negotiations this summer there has been no tangible progress in negotiations and the patience with the UK among EU leaders seems to be running out with around six or seven more weeks to negotiate.

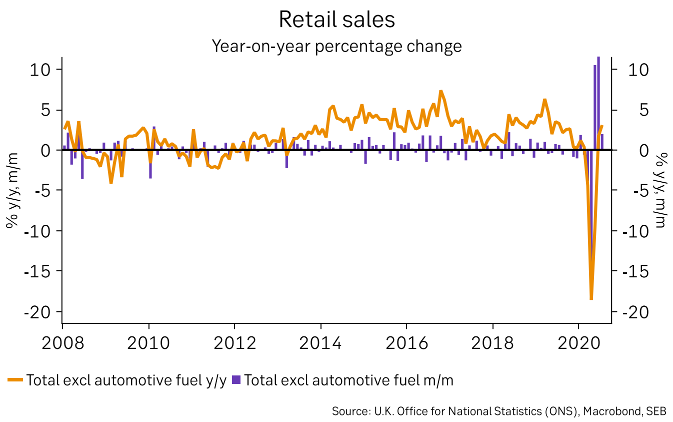
Undoubtedly the risk that negotiations will fail is rising by the day. Not the least after the British government has suggested legislation to round part of the withdrawal deal agreed last year. However, we have seen this situation several times before in these withdrawal negotiations. Our main scenario still includes a limited trade deal being reached this year, which will avoid trade between EU and the UK on WTO terms in 2021. The alternative would be very costly for both the EU and in particular the UK, not the least as both regions are already struggling with their economies falling sharply on the back of the COVID-19 lockdown. The departure from the EU and the lack of progress in negotiations of a future relationship has partly undermined the GBP and is likely to continue to do so until the risk of failed negotiations is eliminated completely. With a deal sealed we instead see some of the risk premium on the GBP being removed and the GBP should take back some lost ground for good.

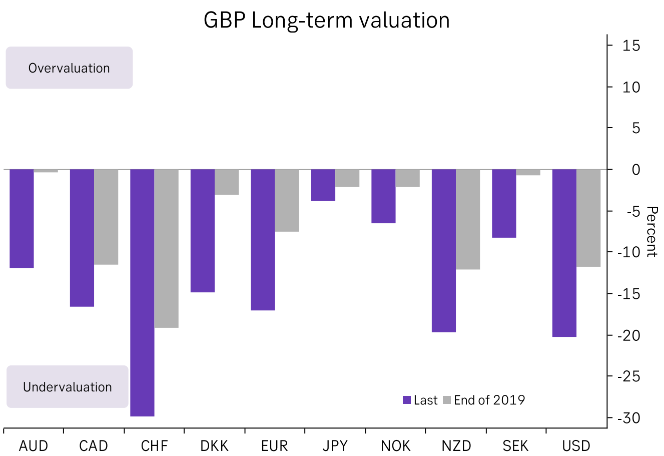
Policy rate will stay above zero for now

The BOE acted swiftly in March with rate cuts to 0.1%, the introduction of new facilities and kick-starting old facilities to provide liquidity. The bond purchase programme was restarted with the target of holding GBP 745bn of mostly government bonds by the end of this year. In contrast to his predecessor, the new BOE governor Andrew Bailey has been more open minded about using negative interest rates and there have been some positive comments from other members of the MPC as well. However, in the August MPR negative interest rates were discussed but downplayed as they could affect banks' balance sheets and their willingness to lend money negatively. As long as banks have a key role in the recovery by providing finance to companies and households, negative rates are therefore seen as a less effective tool. Although the BOE is unlikely to cut rates below zero at present the door is not completely closed. Market pricing indicates a









small probability of moving into negative rates in H2 2021. Would the BOE take this step it will certainly weaken the GBP we don't see it happening.

After years of Brexit uncertainty, growth has been weaker in the UK than elsewhere. Prior to the COVID-19 outbreak we had expected the economy to remain weak this year and next as uncertainty on Brexit and a trade deal prevailed. This had put the British economy in an already vulnerable position to handle the COVID-19 crisis and the British economy reacted more negatively in Q2 when GDP fell by 20.4% from the previous quarter, the most in more than 300 years and much more than the -11.8 % in the euro area. One reason for this is that much of the contribution to growth in recent years has been related to household spending amid a strong labour market and strong wage growth. However, on an aggregated level it seems that households have exhausted much of their reserves. So far government programmes like the job retention scheme have prevented a sharp increase in unemployment as workers have been furloughed. This scheme will now be withdrawn gradually and will close at the end of October. This is likely to cause rising unemployment as some of the jobs lost in the pandemic will never return. As households face rising unemployment and much slower wage growth, spending is likely to be weak going forward, which will hurt growth in the UK. That said, we expect a sharp recovery in GDP in H2 this year but it will probably take until 2022 before production is back where it was by the end of 2019, which suggests low inflation and low wage increases going forward.

Undervalued, but for good reasons

The GBP has been undervalued against the euro and most other G10 currencies since the Brexit referendum in 2016. Today the GBP remains the most undervalued currency among all G10 currencies. According to our long-term fair value model the equilibrium exchange rate for the EUR/GBP is 0.78, while it has moved to 1.57 in the GBP/USD. This suggests that the GBP is undervalued by around 15-20% against major currencies. These results also match the GBP valuation from a competitive perspective, based on relative ULC between the UK and its trading partners. Since the Brexit referendum the GBP has traded with a risk premium related to the risk that the UK would leave the EU without a trade deal in place. This would mean tariffs and trade restrictions on its trade with its single most important trading partner, the EU. Still, if the outcome later this year is unfavourable, today's valuation would not stop further depreciation of the GBP. In contrast if the UK and the EU reach some sort of trade agreement, today's valuation would not be justified and we should expect the GBP to recover.

EUR/CHF

A glimmer of hope for the EUR

The strong recovery for risk appetite has stabilised the EUR/CHF. However, so far, the cross has not gained much following the approval of the European recovery fund of EUR 750bn, which seems to have been the catalyst for the EUR rally witnessed during the summer. Recent SNB FX reserve data indicates that the central bank has temporarily stopped FX interventions, i.e. capital inflows are abating. We stick to the view the cross has bottomed and is a buy on dips.

	14 sep	3M	6M	12M	Q4 21	LTFV*
EUR/CHF	*1.08*	1.08	1.09	1.11	1.12	1.23
USD/CHF	*0.91*	0.92	0.92	0.90	0.90	1.00
CHF/SEK	*9.67*	9.56	9.30	8.94	8.79	7.75
CHF/NOK	*9.93*	9.93	9.63	9.21	9.11	7.87
GBP/CHF	*1.17*	1.21	1.26	1.32	1.36	1.57
ECB	*0.00*	0.00	0.00	0.00	0.00	
SNB	*-0.75*	-0.75	-0.75	-0.75	-0.75	

*Based on the SEB LTFV model

EUR/CHF low remains, for now. EUR/CHF started the year in a falling trend and the appreciation of the CHF continued amid falling risk appetite in March and April. As the ECB took strong measures to support the economy (expanded quantitative easing of EUR 600bn at the meeting in June) and European leaders approved the substantial rescue fund of EUR 750bn mid-July, capital inflows to the CHF has abated as the risk premia on EUR-denominated assets have declined. The trade-weighted EUR has gained but the CHF remains strong, despite the approval of the rescue fund. We expect the EUR/CHF to establish a new trading range of 1.08-1.12. However, Switzerland seems to be coping with the strong CHF, and so, long-term, we fail to see why the EUR/CHF would return anywhere near the levels of 1.20 and beyond.

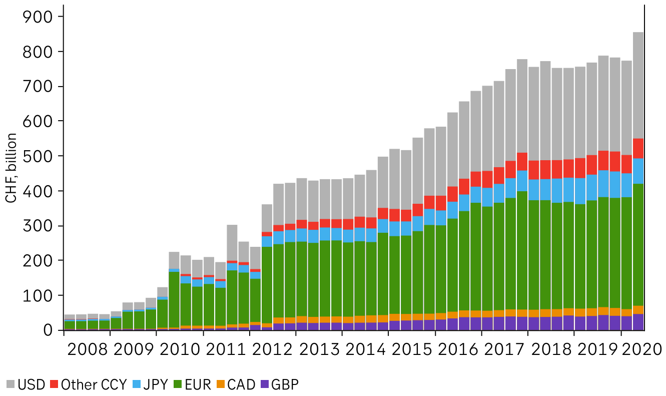
Economic recovery in line with European peers. The Swiss economy was doing relatively well prior to the Covid-19 crisis and, despite a strong currency, grew by 2.8% and 0.9% in 2018 and 2019, respectively. At the beginning of 2020, unemployment was at a very low level (2.3%) and the employment rate was the second highest in Europe. During Q2, the economy contracted by 8.2% q/q after falling 2.5% q/q in Q1. The SNB expects GDP to fall by 6% in 2020 followed by a significant recovery in 2021. According to leading indicators, the Swiss economy should recover relatively quickly. Inflation has long been developing far below the SNB's 2% target while the HICP is currently declining by 1.4% y/y.

SNB runs a dual mandate? The SNB remains far from reaching its inflation target, and inflation has been running below target for a very long time. In the latest Monetary Quarterly Bulletin, the SNB projects inflation to average 0% in 2020-2021. Average annual inflation since the financial crisis in 2008/09 has also been close to zero and hence it is fair to say that the SNB has failed to reach its inflation target, despite massive expansionary monetary policy initiatives. The strategy has instead been to "manage" the CHF to prevent it from rising too quickly. The continued accumulation of FX reserves underlines SNB's strategy of running "dual mandates", i.e. pegging the CHF whilst trying to boost inflation.

FX Reserves have stabilised. FX reserves rose by almost CHF 100bn during March and April. Since then, the SNB seems to have paused FX interventions as capital inflows to Switzerland declined. Clearly, the SNB must be relieved by the latest policy initiatives from Europe as the EUR/CHF has finally left the "1.05-floor" and is trading at almost 1.09. However, the SNB remains on high alert regarding the level of the CHF, which is still overvalued, according to the SNB. Hence, SNB will continue to intervene in the FX market should the CHF appreciate again.

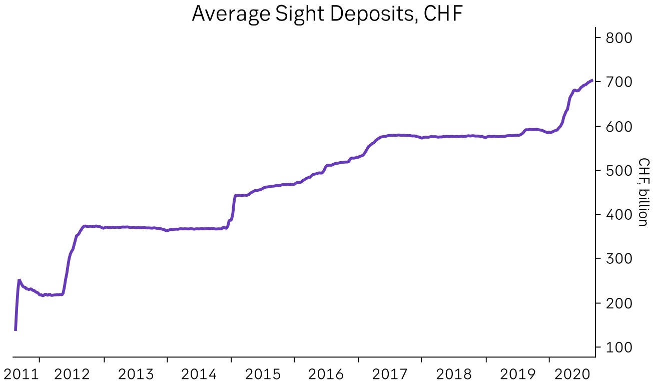
Massive external surpluses remain. Switzerland continues to show very sizeable external surpluses in its trade balance and its current account. The fact that the trade surplus is growing faster than the economy, despite what is perceived by most models as an overvalued CHF, is frankly fascinating. Switzerland posted its highest ever trade surplus in 2019, pharmaceuticals exports increased the surplus to CHF 37.3 bn, overall exports rose by 3.9% to CHF 242bn, driven almost entirely by companies such as Novartis and Roche. Net exports to the US is almost as big as the overall trade surplus making Switzerland qualify as a "currency manipulator" (trade surplus versus the US above USD 20bn). Still, the SNB is forgiven for intervening in the FX market, but the external surplus is clearly another sign that perhaps the CHF is not overvalued at all. So far during 2020, the current account continues to show a sizeable surplus (+10.1%/GDP in Q1 2020) but there will likely be a temporary set-back in Q2 and Q3 due to Covid-19.

SNB: FX reserves



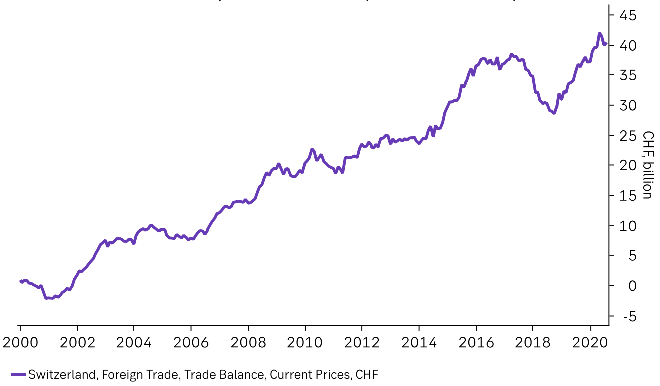
Source: National Bank of Switzerland (Schweizerische Nationalbank), Macrobond, SEB

Switzerland, Monetary Statistics, Monetary Aggregates, M1, Average Sight Deposits, CHF



Source: National Bank of Switzerland (Schweizerische Nationalbank), Macrobond, SEB

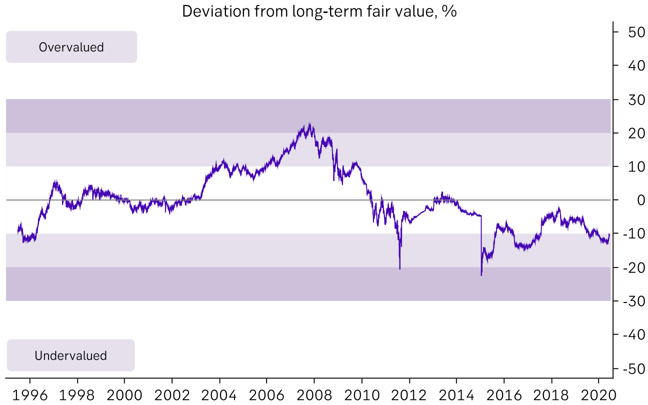
Switzerland, Trade Balance, Current Prices, CHF



Source: Swiss Federal Customs Administration, Macrobond, SEB

EUR/CHF

Deviation from long-term fair value, %



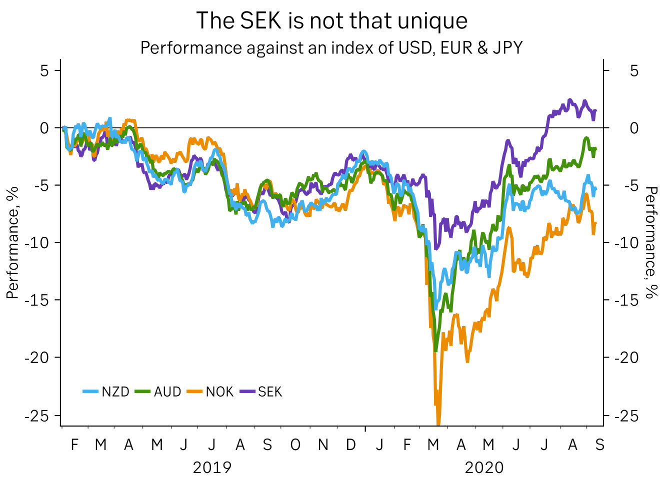
Long term, we believe the CHF will have to weaken and that a long-term target for the EUR/CHF of around 1.15 is reasonable. The continual CHF-appreciation combined with large, external surpluses being maintained makes the long-term risks skewed towards a stronger CHF for a longer period. Switzerland is also running the risk of being labelled a currency manipulator by the US, something which may not matter much on face value, but is indicative of the ability of the country to combine a strong (not weak) currency with solid external competitiveness.

Long-term valuation. During the financial crisis in 2008/09 and during the euro area debt crisis in 2010-2012, the CHF served as a ‘safe haven’ currency. It then attracted vast capital inflows from across the world, which caused it to appreciate significantly. The situation had altered quite rapidly: previously, the CHF had been significantly undervalued against the EUR since the early 2000s, but now it appears overvalued, according to our valuation approach. Today, our estimate for the equilibrium exchange rate in the EUR/CHF is around 1.20, where it has been quite stable since 2014. This suggests that the EUR/CHF is trading 10% above fair value. It looks a little different though when instead considering the competitiveness of the Swiss economy based on relative unit labour costs (ULC). After the financial crisis, the ULC-development in Switzerland was moving alongside the EUR area ULC. However, since 2015, the situation is back to normal, which means much faster growth in the EUR area ULC. The difference since 2015 suggests that the nominal EUR/CHF should trade roughly 10% lower compared to 2015 for the EUR area to maintain its competitiveness, which is at 1.10. The enduring 10% current account surplus is yet another sign that perhaps the CHF is not as overvalued as most models indicate.

EUR/SEK

Heading below 10

The Swedish krona has been undervalued against many currencies in recent years. Since mid-March, it has gained around 8% against the trade-weighted KIX exchange rate index. In fact, so far this year the krona has climbed against most of the 21 KIX currencies. In other words, what has occurred is a broad-based appreciation to its strongest position in over two years. Yet the krona remains undervalued. We expect further gains in the coming year.



	14 sep	3M	6M	12M	Q4 21	LTFV*
EUR/SEK	*10.42*	10.33	10.14	9.92	9.85	9.50
USD/SEK	*8.77*	8.75	8.52	8.00	7.94	7.76
NOK/SEK	*0.97*	0.96	0.97	0.97	0.97	0.98
GBP/SEK	*11.28*	11.56	11.76	11.76	11.99	12.19
JPY/SEK	*8.28*	8.42	8.27	7.92	7.94	8.63
ECB	*0.00*	0.00	0.00	0.00	0.00	
Riksbank	*0.00*	0.00	0.00	0.00	0.00	

*Based on the SEB LTFV model

Even before the COVID-19 crisis we expected the krona would recover from its weak exchange rates as Sweden shifted to a less extreme monetary policy. Because of the COVID-19 outbreak, the adjustment in Swedish interest rates relative to those of other countries occurred in only a few months. The krona has consequently climbed faster than we previously expected. The value of the krona is often measured against the trade-weighted KIX exchange rate index, which consists of 21 currencies of importance to Swedish foreign trade. According to KIX, the krona is today at its strongest level for more than two years and since the beginning of the year it has outperformed most of the 21 currencies. We now foresee further krona appreciation. The EUR/SEK exchange rate is expected to drop to 10.00 by the end of 2020 and reach levels below 10 by the first half of 2021. After that we expect slower krona appreciation, with the EUR/SEK rate reaching 9.85 at the end of 2021.

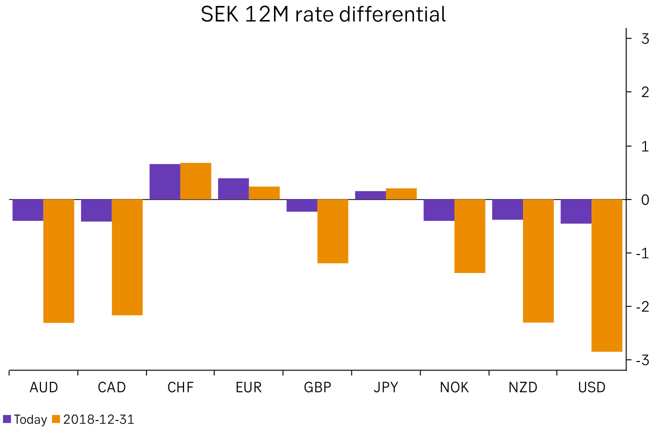
Broad recovery for the SEK

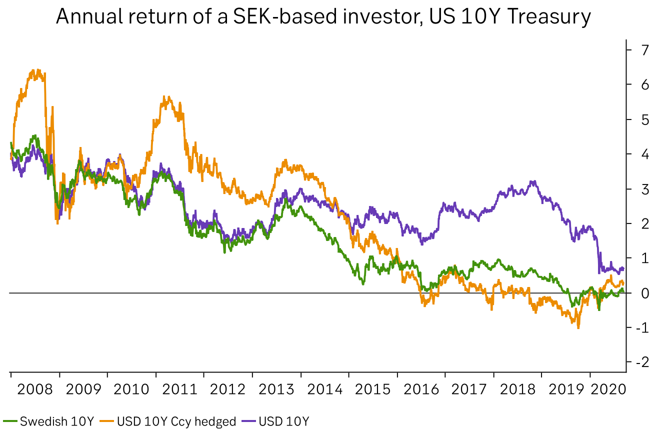
Behind this krona appreciation are several factors that are now pulling in the same direction: higher risk appetite and rising share prices; the krona's attractive valuation; foreign exchange (FX) market positioning, with market players having probably been underweighted in the krona over the past couple of years; narrowing interest rate differentials between Sweden and other countries; and the milder negative impact of the COVID-19 crisis on Swedish growth compared with similar economies, due to the use of guidelines rather than tough rules on social distancing.

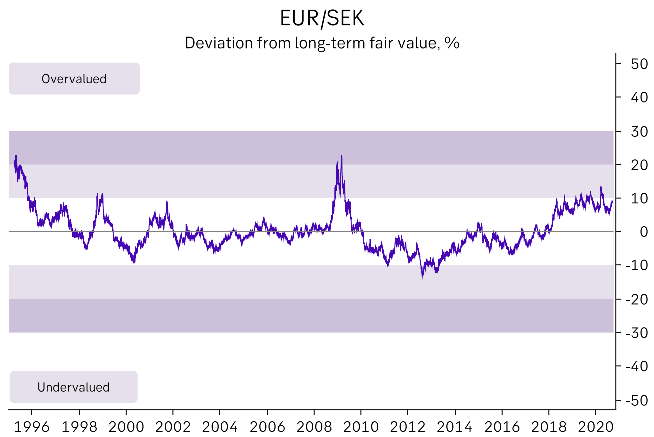
Major shifts in relative interest rates

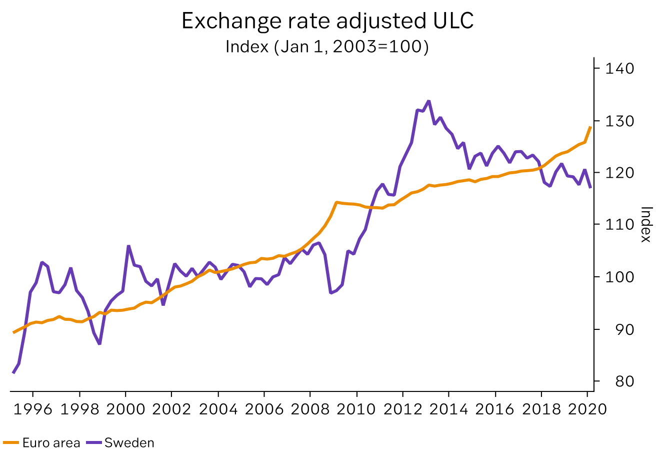
Interest rates are key for exchange rates as relative interest rates determine the forward purchase price of currencies, i.e. the cost of hedging. In 2011 when the USD/SEK briefly traded below 6.00 Sweden's key interest rate was substantially higher than that of the US. Since then both the krona and Swedish interest rates have trended lower against both the dollar and US interest rates and reached extreme levels by the end of 2018. The 12M rate differential had then fallen by 5.6pp while the krona had lost nearly half its value against the dollar. Until 2014, higher Swedish short-term interest rates enabled Swedish bond investors to earn far higher returns from US Treasury bonds by simply eliminating the dollar exposure in these holdings. These conditions changed dramatically when the US Federal Reserve began hiking its key interest rate in late 2015, while the Riksbank did the opposite and slashed its key rate to -0.5%. Since 2016, currency-hedged holdings of US Treasury securities have generated a lower return than the equivalent Swedish bonds with the same maturities, even though nominal bond yields in the USD have been substantially higher.

Since late 2019 relative monetary policy has again changed dramatically. The Riksbank hiked its repo rate to 0%, while the Fed cut its key rate to nearly 0% and aggressively expanded its balance sheet. The yield spread between Swedish and US 10-year government bonds today is only slightly above 0.5% and a Swedish investor can again earn yields above the domestic alternative by owning US treasury bonds without currency risk. This rapid and dramatic monetary policy change has created a need to reduce USD exposure by purchasing kronor and selling dollars. We have estimated the dollar exposure of Swedish institutions at the end of 2019 as being the equivalent of about SEK 500bn and this is probably the single most important reason why the krona has appreciated recently.









Because of narrow rate differentials, the krona is also no longer an obvious funding currency among more speculative FX market players, and Swedish export companies are likely to increase their currency hedging levels as the cost has fallen. Swedish institutional investors will probably continue to reduce their foreign exchange exposure. For good reasons, various FX market players have been underweighted in kronor in recent years, but this will probably not be the case in the future.

Swedish COVID-19 strategy also favourable

The milder impact of COVID-19 benefits the krona. This means there is good potential for the krona to continue appreciating from today's levels against many currencies, including the euro. Another factor that benefits the krona is Sweden's management of the COVID-19 outbreak, which seems to have had milder consequences for the economy than in other countries. During the second quarter of 2020, Swedish GDP preliminarily fell by 8.7% compared with the same quarter of 2019. This was less than in both the US (-9.5%) and the euro area (-15%). If Sweden makes it through the COVID-19 crisis with somewhat less damage than other countries during the next few quarters as well, this may also benefit the krona. Meanwhile Sweden's central government finances are considerably stronger than those of many comparable economies. Because of low central government debt at the outset and a degree of moderation during the COVID-19 crisis, there is still potential to stimulate demand in a sustainable way via fiscal policy if the need arises in the future. This can also be expected to benefit the krona.

The krona has been weak for some time

Our long-term currency valuation model based on a number of fundamental variables that usually determine a currency's equilibrium exchange rate indicates that the SEK has been greatly undervalued against both the euro and US dollar in recent years. According to our models, the EUR/SEK equilibrium exchange rate is between 9.50 and 10.00 and the USD/SEK equilibrium rate is7.50-8.00. These levels have been relatively stable in recent years (see charts below). This means that at today's exchange rates the krona is still undervalued and should be able to appreciate further in the future against both the EUR and the USD.

A weak SEK has improved trade balance

In recent years the Swedish current account surplus has improved significantly. The improvement in the current account balance is mostly related to a rapid increase in the surplus in goods trade with the rest of the world. Moreover, there has also been an improvement in the net return on investments, where Swedish overseas investments currently generate much more revenue than foreign investments in the country.

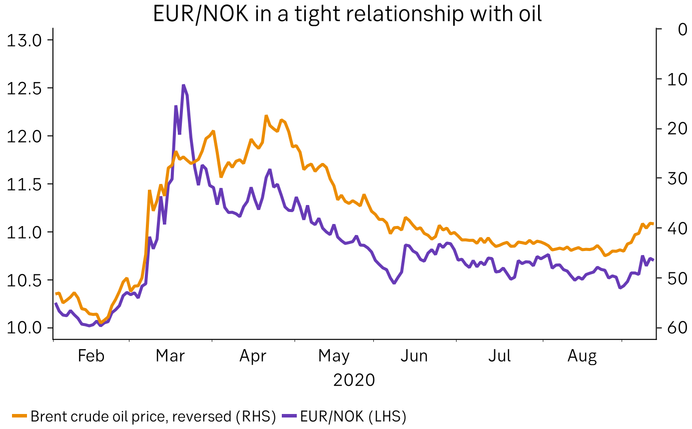
This has enabled the country to reduce its foreign debt. For the past decade, Sweden's assets abroad have been larger than the assets of foreign owners in Sweden. This is also true of equities, with Sweden's foreign shareholdings being larger than foreigners' shareholdings in Sweden. This serves as a cushion when there are large share price declines and probably helped to limit krona depreciation during the most acute phase of the COVID-19 crisis in February and March A low valuation and the fact that many market players were already underweighted in kronor may also have helped the SEK to perform better than many other small currencies.

EUR/NOK

Short-term headwinds to our bearish outlook

EUR/NOK has corrected during the summer, driven by the positive global risk sentiment and a recovery in oil prices. Generally large uncertainty ahead of high-risk events this autumn and downside oil price momentum will put upside pressure on EUR/NOK towards year-end. However, we maintain our bearish long-term EUR/NOK outlook and believe autumn rallies offer a good opportunity to position for a move lower in 2021.

EUR/NOK in a tight relationship with oil



Source: Bloomberg, Macrobond, SEB

	14 sep	3M	6M	12M	Q4 21	LTFV*
EUR/NOK	*10.69*	10.72	10.50	10.22	10.20	9.64
USD/NOK	*9.00*	9.08	8.82	8.24	8.23	7.88
NOK/SEK	*0.97*	0.96	0.97	0.97	0.97	0.98
GBP/NOK	*11.60*	11.99	12.18	12.12	12.42	12.37
JPY/NOK	*8.50*	8.74	8.57	8.16	8.23	8.76
ECB	*0.00*	0.00	0.00	0.00	0.00	
Norges Bank	*0.00*	0.00	0.00	0.00	0.00	

*Based on the SEB LTFV model

Short-term: Upside risks dominate

Oil and risk appetite are driving EUR/NOK. The krone has benefitted from the general positive risk sentiment in markets during the summer, which has directly supporting the krone as a small and less liquid currency, and indirectly via a higher oil price. The strongest move has been against the dollar, but by the end of August, the EUR/NOK had almost corrected back to its February level. However, the krone remains vulnerable against setbacks in oil prices and the krone has underperformed all G10 currencies so far in September. Analysis of empirical data shows that weekly changes in EUR/NOK are best explained by the oil price and global risk sentiment (measured by our own risk appetite index). This is not surprising, but the explanatory power has increased significantly this year compared with the last 5 years. What's also interesting is that the relative rate spread doesn't really explain any of the weekly EUR/NOK changes besides those weeks in March with heightened financial stress. In the short-term, we expect these drivers to remain, implying that the EUR/NOK outlook is dictated by global factors, rather than domestic ones in the short-term.

A nervous autumn in markets. The strong policy response to the pandemic has fuelled risk appetite and most procyclical currencies during the summer. As discussed in the international section of this report, there are uncertainties about the sustainability of the economic recovery which may jeopardise the stock market upturn. Several important events are scheduled this autumn which contains large event risks; a messy and contested US presidential election and increased US-China tensions as part of Trump's presidential election. Moreover, the risk of UK-EU trade negotiations failing has increased, but we expect the parties to eventually reach a limited trade deal before year-end. A globally approved vaccine will certainly fuel risk sentiment (and oil prices), but we assume that a vaccine may be in place by early 2021 at the best.

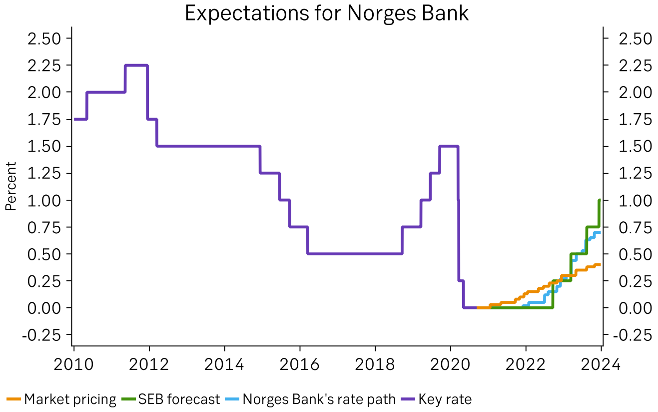
Downside oil price momentum maintained. The Brent crude spot price has fallen by almost 12% during September to near $40/bl. This has occurred in a more broad-based risk off sentiment. The downside momentum has also been fuelled by an elevated net speculative long position in WTI. Although positions have been scaled down, the market remains long and thus vulnerable towards further setbacks in risk sentiment this autumn. Fundamentally the outlook will improve from next year (see next page).

EUR/NOK seasonality: Bullish Q4, bearish Q1. The NOK has a clear tendency to end the years on a weak footing, but to start them strong. Over the past 7 years, EUR/NOK has risen 6 out of 7 years in Q4 with an average increase of 3.4%. This is due to an average rise of 1.1% in October, 1.4% in November, and 0.9% in December. In 2020, however, EUR/NOK peaked in mid-Dec and corrected rapidly towards year-end. This was probably due to an early short positioning ahead of the seasonal bearish start of the year. A similar pattern may be visible this year should autumn rallies in EUR/NOK create attractive entry levels for speculative shorts. The currency pair has on average fallen by 1.3% in Q1 (7/10 years) with the largest move materialising in January (1.1% on average). The seasonality pattern vs. SEK is even more robust (see table on p.2).

Sell EUR/NOK on rallies this autumn. Our main scenario is that large uncertainty and event risks during the autumn will result in temporary consolidation in both stock markets and EUR/USD during Q4. This, combined with downside oil price momentum, is likely to sustain upside pressure in EUR/NOK in the short-term. However, we regard rallies in EUR/NOK towards 10.80/10.90 as a good opportunity to position for a seasonal move lower in early 2021 and to benefit from our long-term bearish outlook.

	EUR/NOK				NOK/SEK			
	Q4	Oct	Nov	Dec	Q4	Oct	Nov	Dec
2013	2,5	-0,8	3,1	0,2	-0,9	2,0	-2,1	-0,8
2014	10,6	4,1	3,5	2,9	-6,9	-2,5	-3,3	-1,2
2015	0,9	-1,9	-1,7	4,5	-2,7	2,4	-0,1	-5,0
2016	1,2	1,0	-0,5	0,7	-1,7	2,0	-1,0	-2,7
2017	4,6	1,2	4,0	-0,6	-2,5	0,4	-1,8	-1,0
2018	4,9	1,0	2,2	1,7	-6,5	-0,3	-2,8	-3,4
2019	-0,5	3,3	-0,9	-3,0	-1,7	-3,0	-1,3	2,6
Avg (%)	**3,4**	**1,1**	**1,2**	**-0,3**	**-3,1**	**-0,2**	**-1,7**	**-1,1**

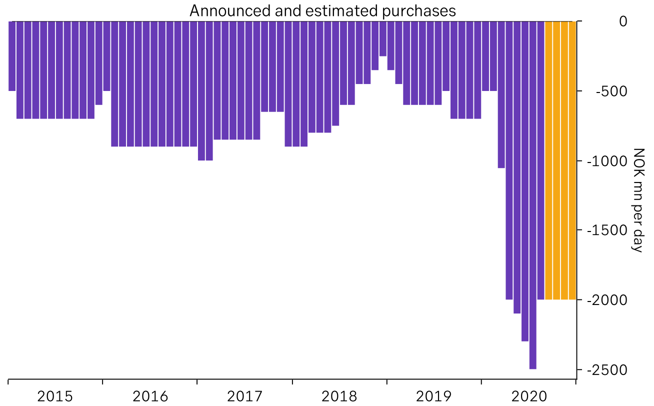
Expectations for Norges Bank



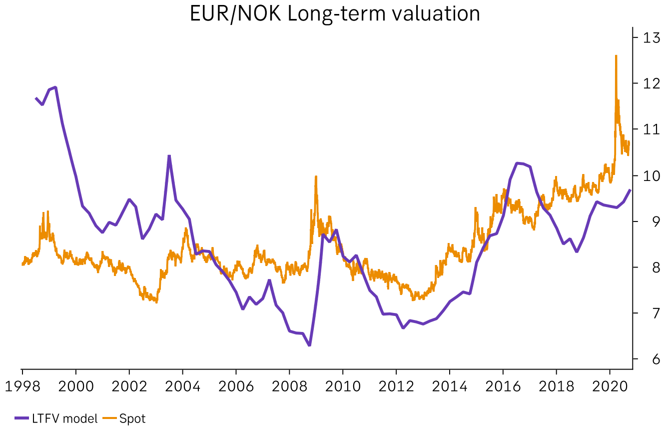
Source: Bank of Norway (Norges Bank), Macrobond, SEB

Norges Bank daily FX purchases

Announced and estimated purchases



EUR/NOK Long-term valuation



Long-term: Outlook remains bearish

The collapse of the krone during the pandemic created a large undervaluation against other G10 currencies. Although the krone has partly recovered from the slump, we reiterate our long-held view that the NOK is undervalued against the EUR. The ongoing global recovery, possible large-scale vaccinations, and continued global monetary and fiscal support are likely to contribute to EUR/NOK resuming its downward trend in 2021. Moreover, although currency-specific factors and valuation are not currently important drivers for exchange rates, their importance may rise over the coming years. Hence, we maintain our long-held bearish view on EUR/NOK and forecast a move to 10.20 by end-2021.

Domestic factors will be supportive. Once the market's focus gradually shifts towards policy normalisation, domestic fundamentals will again turn more important. The NOK should benefit as the setback in the Norwegian economy will be less severe than in the Eurozone and the US. Effective income support and record-low interest rates have spurred household demand. The side-effect of this has been a surge in home prices and a renewed increase in household credit growth. The build-up of financial imbalances is likely to trigger Norges Bank to be among the first central banks to start hiking rates. Norges Bank proved in 2019 that it can be "the odd man out" and is backed by its flexible inflation target, which allows for the bank to lean against the wind. We expect Norges Bank to start hiking rates in autumn 2022 and deliver a total of 4 hikes before end-2023. Norges Bank's relative hawkish stance should support a long-term appreciation of the NOK.

Higher oil prices in 2021-2022. We see a strong fundamental case for a higher Brent oil price in 2021-2022. OPEC+ is expected to maintain its supply restraints to April 2022, while the revival in US shale oil is likely to be more cautious this time around. Moreover, although global oil demand is currently weak, we expect an accelerated tightening of the global oil market over the coming two years with the supply/demand balance shifting into a deficit. We forecast an average Brent crude oil price of $55/bl in 2021 and $65/bl in 2022, which is above its long-term average. Assuming continued high correlation between EUR/NOK and the oil price, our forecast underpins our long-term bearish outlook.

Norges Bank's NOK purchases. Fiscal policy support and low tax revenues have created a large budget deficit of almost NOK 400bn this year which is funded from the oil fund. Since the oil fund only invests in foreign assets, this has created a large net capital inflow into NOK. Norges Bank is currently buying NOK 2.0bn per day on behalf of the government and will probably continue at this pace for the rest of the year. This is a substantial volume, which gives underlying support to the krone for the rest of the year.

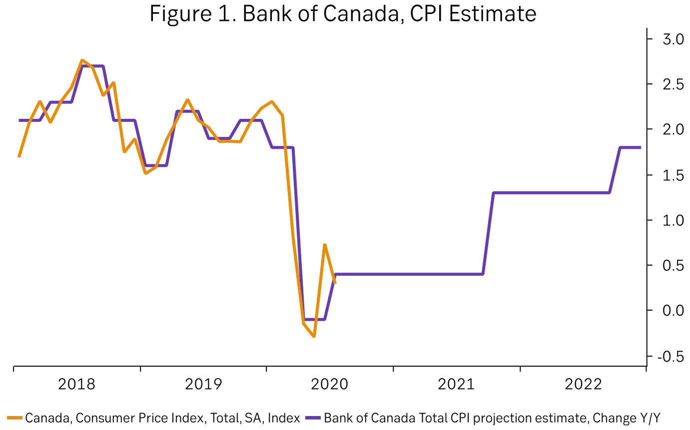
NOK valuation gap persists. The NOK is one of the currencies most undervalued against other G10-currencies according to our fair value approach. That was certainly the situation after the oil price shock and the market panic earlier this year when the EUR/NOK briefly reached a new record level. Although the NOK has recovered significantly since then it is still far away from what we regard as its long-term equilibrium level. The fair value estimate in the EUR/NOK has been grinding higher together with the spot level since 2012. Today, the long-term fair value for EUR/NOK is 9.70 compared with around 7.00 eight years ago. There is always worth recalling that these kind of long-term estimates are more uncertain for the NOK than for other currencies due to the set-up with the oil fund which may distort the empirical relationship between fundamental variables and the NOK. Nevertheless, valuation remains a positive factor for the NOK.

USD/CAD

Slowing recovery and the US presidential election to support USD/CAD

The Bank of Canada is likely to keep the current ample monetary policy support in place for quite some time. We believe that the rest of the year may turn out to be difficult for the CAD due to slowing recovery, low oil price and the US presidential election supporting the dollar. However, a slightly weaker CAD this year is likely to be followed by a slowly strengthening Canadian currency next year.

Figure 1. Bank of Canada, CPI Estimate



Source: Bank of Canada, Statistics Canada, Macrobond, SEB

	14 sep	3M	6M	12M	Q4 21	LTFV*
USD/CAD	*1.32*	1.34	1.33	1.30	1.29	1.27
EUR/CAD	*1.56*	1.58	1.58	1.61	1.60	1.56
CAD/SEK	*6.66*	6.53	6.41	6.15	6.16	6.11
CAD/NOK	*6.84*	6.78	6.63	6.34	6.38	6.20
GBP/CAD	*1.69*	1.77	1.84	1.91	1.95	2.00
Fed funds	*0.25*	0.25	0.25	0.25	0.25	
BOC	*0.25*	0.25	0.25	0.25	0.25	

*Based on the SEB LTFV model

Monetary policy to remain expansionary for a long time

In the monetary policy meeting last week, the Governing Council noted that the activity in Q3 seems to be stronger than in the July projections. This is mainly due to the strong goods consumption and housing activity, reflecting the pent-up demand during Q2. The July economic projection was based on the USD 40 Brent and WTI price forecasts, which are largely in line with the current pricing. The relatively strong rebound during the summer is mainly a mechanical response to switching the lights back on in the economy, and activity will slow down ahead. This is also the view of the Governing Council and according to the July forecast, the annual inflation rate is not expected to reach 2% before late 2022 (see figure 1). The Canadian economy will continue to require extraordinary monetary policy and fiscal support for quite some time before the slack in the labour market has been erased. Google mobility data suggests that although the activity in consumer staples has recovered largely to the pre-pandemic levels, discretionary spending and especially transportation are still well below normal levels (see figure 2). According to the BOC, exports and business investments will recover very slowly during the coming two years. The oil sector clearly faces a lot of headwinds for quite some time, which has second order effects on the wider economy.

The bank has decided to continue to buy CAD 5bn of government bonds until the recovery is “well under way”. The balance sheet was rapidly increased from CAD 120bn to around CAD 550bn during the early stages of the COVID-19 pandemic. The rapid response by the BOC provided the much-needed liquidity for the banks, stabilising the financial markets and keeping credit flowing to households and businesses. However, it is worth noting that the size of the balance sheet has not been growing during the past months because the bank does not seem to re-invest T-bills, but rather replace maturing T-bills with the government bonds (see figure 3). The surprisingly rapid recovery, especially in the housing market, has raised some questions about whether the BOC is planning to scale-back the liquidity support and reduce its balance sheet. We believe such speculations are premature and the monetary policy will remain very accommodative for a long time. The CAD OIS market implies rate hikes to begin in two years’ time, in line with the USD OIS market pricing. From the relative monetary policy perspective, very little is expected to happen during the rest of the year, with no material pressure on the USD/CAD in either direction. The oil market and exports are also expected to recover very slowly, giving very little reason to expect stronger CAD during the rest of the year.

As we discuss in the EUR/USD article, Q4 is likely to be difficult for risky assets due to the slowing recovery in Q4 and the US Presidential election, resulting in a risk of a temporarily stronger dollar. In particular, given that the spot rate is at the low-end of the pre-pandemic 1.30-1.35 range and close to both our short-term and long-term fair value (more on the next page), weakening risk appetite during the rest of the year is likely to lift the spot rate towards 1.35.

Figure 2. Canada Google mobility index, relative to baseline

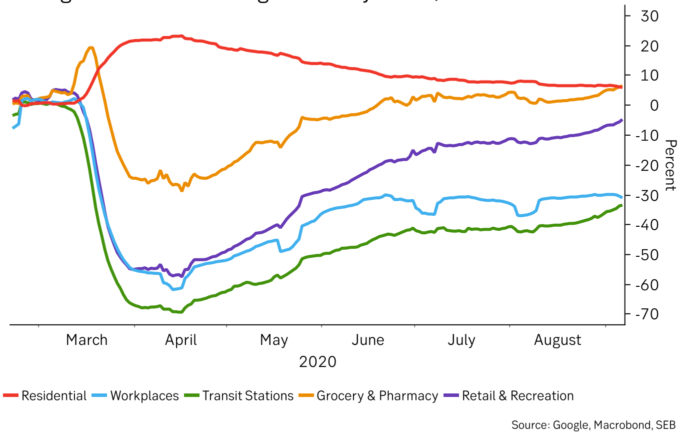


Figure 3. Bank of Canada balance sheet, major assets

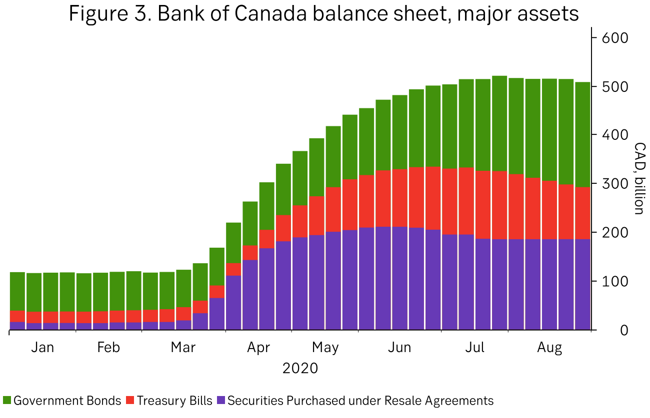


Figure 4. USD/CAD: Monetary policy expectations, oil price and risk sentiment

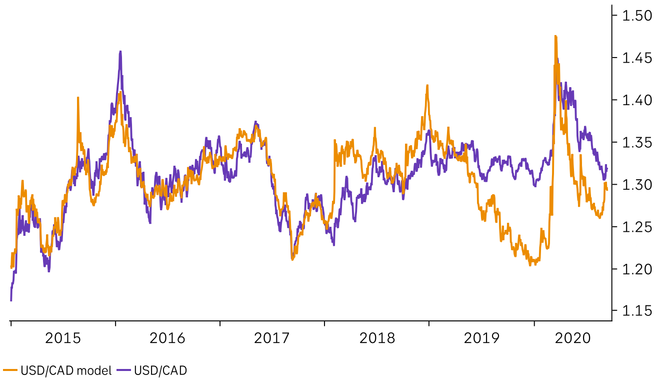
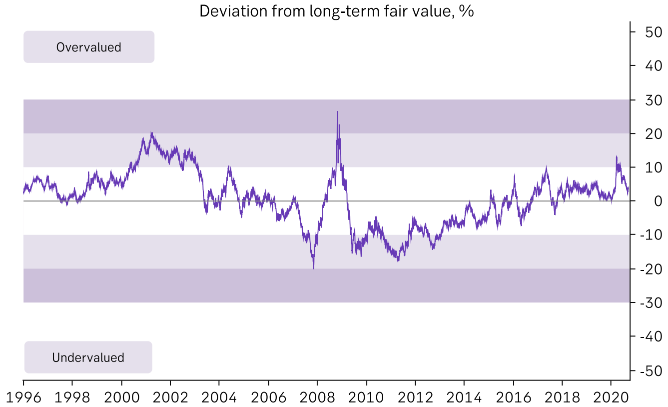


Figure 5. USD/CAD Long-Term valuation model

Deviation from long-term fair value, %



Short-term model: Monetary policy less important for now

Our short-term model suggested a considerably stronger CAD in H2 last year once the Fed started to cut rates while the BoC kept rates stubbornly unchanged. The FX market probably refrained from getting too excited about the improving CAD carry as the looming rate cuts from the BOC kept CAD bulls cautious. This year the CAD has been tossed around by risk appetite and oil prices rather than the relative monetary policy as both central banks responded simultaneously and aggressively to the COVID-19 pandemic. Our short-term model captured the moves during the height of the crisis in Q2 fairly well, although the historical betas, which were stable during 2015-2018, have changed somewhat during the past year (see figure 4). Very recently the decline in oil prices and deteriorating risk sentiment have pushed the spot rate and the model slightly higher, but we expect the USD/CAD to remain in a fairly tight 1.30-1.35 range in the short-term.

Long-term outlook for USD/CAD is slightly bearish

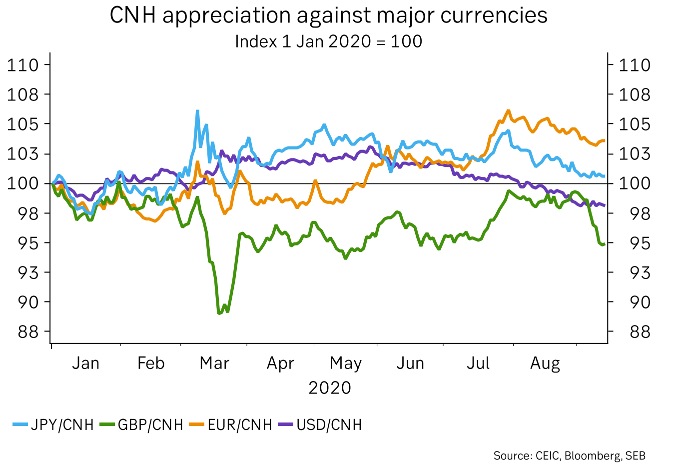
We see a strong fundamental case for a higher Brent oil price in 2021-2022 as OPEC+ is expected to maintain its supply restraints to April 2022, while the revival in US shale oil is likely to be more cautious this time around. Moreover, although global oil demand is currently weak we expect an accelerated tightening of the global oil market over the coming two years with the supply/demand balance shifting into a deficit. We forecast an average Brent crude oil price of USD 55/bl in 2021 and USD 65/bl in 2022, which is above its long-term average. This should support the CAD next year together with the continued global recovery. Excluding temporary shocks, the USD/CAD has followed our long-term fair value during the past 5 years quite closely. Our long-term valuation approach indicates a long-term fair value of around 1.30, which is basically where the pair trades today. The relative unit labour costs have been stable during the past years, suggesting that the relative competitiveness puts very little pressure on the currency. Canada's current account deficit has improved over the past two years and if the trend continues into next year, this should further give structural support for the CAD. However, there is a risk that the oil price and demand do not recover as we expect. This could undermine trade and create a similar situation to 10 years ago with a rapidly growing trade deficit. The US current account remains deeply negative, despite a small improvement during the past year. The recovering economy next year is likely to keep the deficit in place for the US. Given our constructive outlook for oil and the global economy for 2021, we expect USD/CAD to trade slightly below 1.30 at end of next year.

Positioning is fairly light. Investors´ small interest in long CAD positions may reflect the difficulties the oil market is having at the moment. In general investors are short the dollar but not particularly vs. CAD. In isolation CAD is rather shorted currency at the moment and it is difficult to draw any strong conclusions about the positioning in USD/CAD at the moment (see the theme article Positioning).

USD/CNY

Fundamentals supportive of yuan

The soft dollar environment benefits the yuan. The broad recovery in market sentiment will keep USD/CNY heavy, likely to end the year at 6.85. Fundamentals are supportive of yuan resilience even if the dollar remains in consolidation in the near term. However, volatility is likely to rise in the run-up to the US elections in November, before allowing USD/CNY to decline further to 6.75 by end-2021.



	14 sep	3M	6M	12M	Q4 21
USD/CNY	*6.81*	6.89	6.86	6.80	6.75
EUR/CNY	*8.09*	8.13	8.16	8.43	8.37
CNY/SEK	*1.29*	1.27	1.24	1.18	1.18
CNY/NOK	*1.32*	1.32	1.29	1.21	1.22
GBP/CNY	*8.79*	9.09	9.47	10.00	10.19
Fed funds	*0.25*	0.25	0.25	0.25	0.25
PBOC	*2.09*	2.10	2.10	2.00	2.00

*Based on the SEB LTFV model

Short-term

The soft dollar environment benefitted the Chinese yuan the three months. After peaking above 7.19 in May, USD/CNH has tracked lower. Since then, the yuan has appreciated around 4.8% against the greenback. Looking forward, we expect US-election related posturing to limit too much downside from here. We expect the pair to end the year at 6.85 before going down towards 6.75 by end-2021. As we have expected, US-China relations continue to deteriorate. Shifting from trade related issues, US policy is now targeting the tech sector, likely leading to more de-coupling between US and Chinese network technologies. Yet, the market has largely ignored such actions, comforted by the persistence of the Phase 1 trade deal. So long as the risk of even higher tariffs are no longer on the table, risk sentiment has been supported by the global recovery.

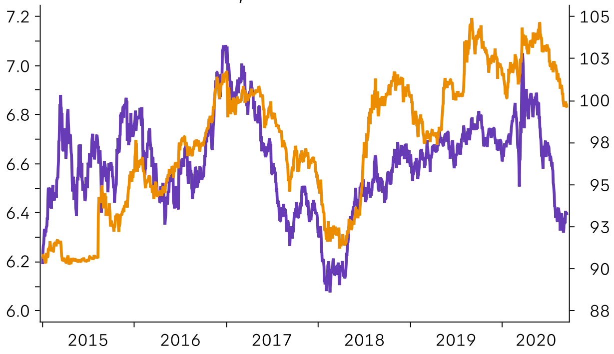
The narrow gap between offshore yuan and the onshore yuan fix implies that the pressure for the yuan to depreciate is low. In the past, the authorities greatly relied on the fix to limit volatility in the yuan. The fact that the fix has not diverged significantly from the offshore rates implies that the authorities are comfortable with current market conditions.

Despite the gains in the yuan, it still lags the gains of major currencies against the greenback. We remain cautious of the risks presented by the US elections. Indeed, the forward market is indicating rising positions to hedge against a pick-up in volatility. Risk reversals in favour of higher USD have been on the rise for the past couple of months, even as spot USD/CNH is on a downtrend. Likewise, the 3m onshore implied yields have risen to levels last seen at the end of January.

Looking past geopolitical risks, fundamentals are supportive of yuan resilience even if the dollar remains on its current consolidation phase. High frequency indicators suggest that economic recovery is on track. Latest PMI readings imply that the recovery in overall demand is broadening. Public investment initially led the charge. Now, external demand for China's exports are also rising as the China's trading partners continue to open up.

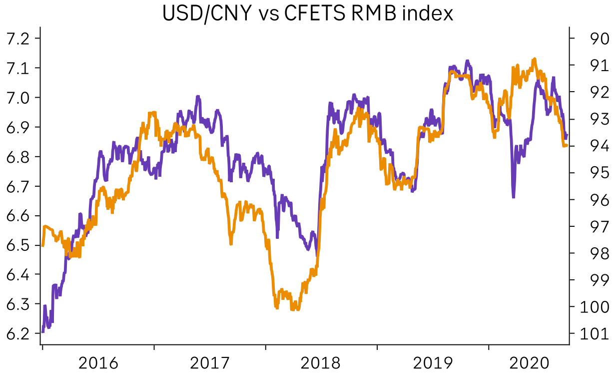
Onshore rates remain elevated. The rate premium of the yuan over the dollar has now widened to almost 250 bps for the 10y government bonds, a record high. The People's Bank of China (PBoC) remains wary of providing cheap liquidity that led to arbitrage opportunities. Since April, yuan rates have been led higher in a bid to raise the interbank rates back to the central bank's loose interest rate corridor. As a result, China's bond curve bear flattened since May after the initial bull steepening at the beginning of the global pandemic. Compared to the US Federal Reserve, the PBoC is relatively hawkish having switched from a less supportive stance. In light of the ongoing recovery, there is less need for the Chinese central bank to pursue more supportive stance in the near term. Instead, we expect the PBoC to continue to favour open market operations and various re-lending facilities to manage the liquidity requirements of the economy. As a result, forward points remain bid with 1yr swap rates now above 1,600.

USD/CNY vs USD index



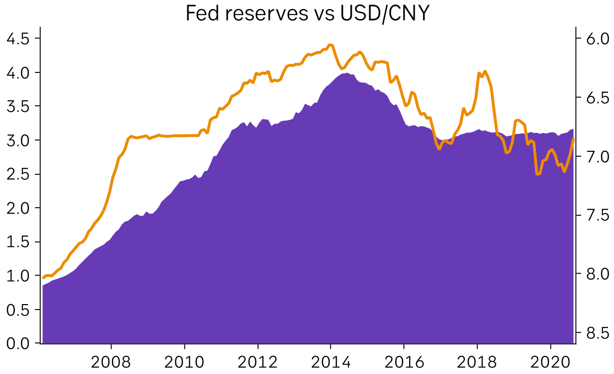
Source: CEIC, Bloomberg, SEB

USD/CNY vs CFETS RMB index



Source: CEIC, Bloomberg, SEB

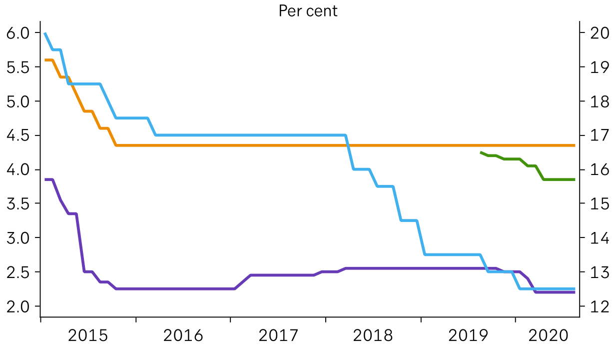
Fed reserves vs USD/CNY



Source: CEIC, Bloomberg, SEB

Monetary policy tools

Per cent



Source: CEIC, Bloomberg, SEB

Long-term

Although economic recovery is ongoing, the first-in-first-out advantage of China may start to taper soon. Furthermore, China's economic recovery is already fully priced in. The space to beat consensus forecasts is narrowing. Indeed, the official PMI reading in August came in lower than median forecasts, the first time in three months. Meanwhile, global recovery is gaining pace. Although there is a resurgence in new case loads in Europe, governments around the world are hesitant to impose nationwide lockdowns yet again. Thus, the growth differential with China is narrowing, which could limit the yuan's appreciation in the medium term.

Meanwhile, Chinese policymakers have introduced the economic model of "dual circulation" as the country's new development strategy. Under the framework, the emphasis will be on developing domestic demand to lower external reliance. The explicit shift in policy underlines that China is turning increasingly inward. Even so, we believe China will continue to dominate global trade.

The recent US policies meant to limit China's tech ambition has led to more investment in new economy industries. The restrictions on Huawei's access to chips have structural implications on Asia's supply chain. In the short run, the tech sector will likely see some reconfiguration which would favour production in South Korea and Taiwan. Yet, in the long run, China's aim to increase the localization rate in the semiconductor industry may lead to a re-orientation of its 5G stategy.

Although the yuan's gain against the greenback is still lagging the move in DXY, the yuan had a strong showing in August against the basket of currencies of its trading partners. In August alone, the RMB Index rose more than 2%. At 93.6, there is a risk that the RMB Index may be approaching a technical resistance to the downtrend channel formed since 2015. Specifically, we would be watching if the RMB Index can breach 95 over the next 6 months.

We expect the PBoC to maintain a relatively light hand in the market. Since 2017, China's FX reserves have been broadly steady at around USD3.1 trillion. This is in sharp contrast to the persistent FX intervention of other central banks in EM Asia, which have pursued aggressive reserve accumulation since April.

In light of the central bank's reluctance to ease monetary policy via interest rates cuts, CNY yields are now the third highest in Asia, coming in behind Indonesia and India. The favourable rate differential will likely remain in the medium term.

China's external position will remain supported by strong portfolio flows. Rebalancing of equity and bond indices is ongoing. The latest change in MSCI EM Index in August led to a broad sell off in Korean equity holdings of foreigners in favour of China shares. In November, the weigh of large-cap China A shares will be raised further to 20% from 15% and mid-cap China A shares will be included with a 20% weight. Considering that foreign positioning in EM Asia equities remains light, we expect the massive increase in global liquidity to seek investment opportunities in Asia to return in the medium term.

FX market themes

US elections

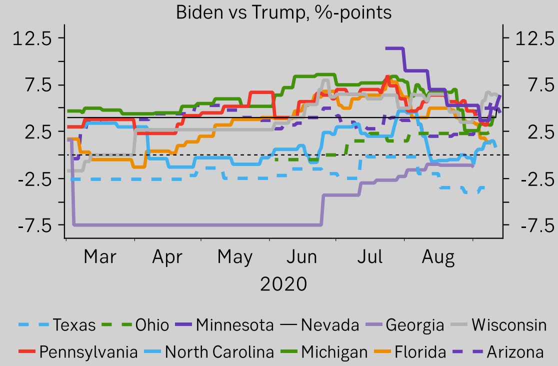
Messy and consequential

A US presidential election is an important event for the US and global economies but seldom a major market driver. There are two reasons why the 2020 elections may be different. First are the larger than usual risks for a messy and contested election. Second, investors face two very different policy agendas. We imagine another Trump term would be dominated by continued tensions with China. Biden will deliver tax hikes and re-regulation but also a green growth push and less drama on trade.

We continue to see Joe Biden as the most likely winner (60% probability) but the race is likely to be a close call. Concerns over the handling of the Covid-19 pandemic translated into a rising support for Biden during the summer. Increased focus on the economy may benefit President Trump, since this is the area where he enjoys the highest approval ratings. State electoral votes decide who wins the election, sometimes by very small margins. Recent polling suggests that Trump has gained on Biden in several swing states, though Democrats have made inroads into traditional Republican constituencies too.

US 2020 elections: Toss-up states

Biden vs Trump, %-points



Source: RealClearPolitics (RCP), Macrobond, SEB

Beware lengthy counting and the blue shift

A polarized population, coronavirus concerns and an increased number of postal votes may turn the 2020 election into a cliff-hanger. In the 2016 election, 21% voted by mail; currently 30% plan to vote by mail, with a large difference between potential Trump (11%) and Biden (47%) voters. This is recipe for conflicts and prolonged market uncertainty. Because Democrats vote by mail to a greater extent, the election outcomes can change during the vote counting. A new phenomenon in the 2018 midterm election was the “blue shift”, in which Republican candidates initially seemed to have picked up more support than predicted, only to lose against Democrats in the final vote count.

One scenario is that Trump proclaims himself the winner on election night, but Biden wins in the final count. Will Trump voters accept such an outcome after Trump has warned for years about postal voting fraud?

On the other hand, a final victory for Trump may be hard for Democrats to accept if they suspect that problems with delivery of postal votes – or other obstructions – played a part. A key challenge for Democrats is that postal votes are rejected to a greater extent than in-person votes and especially for people of colour and the young – groups that are more likely to vote for Biden. Primary elections during the spring were a warning example: in some swing states the number of rejected absentee ballots were close to or in line with Donald Trump's winning margin in 2016. The risk that election outcomes will lack legitimacy among the losing side's supporters may fan the flames of conflict even further in the US, making constructive cooperation in Congress more difficult. There are also constitutional challenges if counting takes too long. Legal issues around the voting process must be resolved before state electors vote on president and vice president by 14 December.

China in focus for a second Trump term

If Donald Trump wins, we expect a continuation of his policies of his past four years, with added emphasis on foreign trade, China and immigration given that the major tax reform and energy deregulation from 2016 have already been delivered. The Republicans have announced no 2020 election platform but refer to their 2016 platform. However, Trump has published a two-page second term agenda. Tax cuts remain high on the agenda, but promises are vague with cuts to *"boost take-home pay and keep jobs in America"* and "*Made in America*" tax credits. Trump has previously proposed cutting or even terminating payroll taxes. Since payroll taxes raised USD 1.2 trillion in 2019, around 6% of GDP, and over a third of total federal revenue this is potentially a huge deal. It would, however, also remove financing of social security and Medicare, which Trump has promised to preserve, making it less likely.

Trump has also talked about lowering capital gains taxes. Further, a Republican presidency is likely to want to extend some of the expiring tax cuts in the 2017 tax reform. None of these taxes are mentioned in Trump's agenda, however. Apart from "Made in America" tax credits (below) it is therefore hard to have an opinion on Trump's tax policy for the next four years, but our main scenario is that tax cuts would be less of a growth driver than during the previous four years. Ending the reliance on China is another key part of the agenda, in line with recent threats of a decoupling. This includes unspecified tax credits for companies that bring back jobs from China and 100% deductions for essential industries like pharma and robotics that bring back manufacturing to the US. Companies that outsource to China will not get federal contracts. Trump will also enact "fair trade deals" that protect American jobs, indicating continued risks for trade conflicts with for instance the EU. Risks of a break-down of the trade deal with China will increase after elections.

Green Left turn with Biden

The Democratic party has shifted left since Obama and Biden must follow, in our view. The 2020 platform includes several tax hikes: taking back parts of the corporate tax cut from the 2017 tax reform (from 21 to 28%), a new 15% alternative minimum tax on books profits, a doubling of the tax on foreign subsidiaries (to 21%) and a 10% surtax on profits on US overseas production for sales back to the US. For individuals, Biden proposes raising the top income tax rate, adding a 12.5% payroll tax on high incomes and tax capital gains as income for those earning above USD 1 million. Excluding higher tax deductions on lower incomes, Biden's tax proposals are expected to generate USD 3.8-4.0 trillion over 10 years, about evenly divided between individuals and companies, and more than double the estimated lost revenue from Trump's tax cuts. Other less business friendly policies include raising minimum wages (to USD 15 per hour by 2026), strengthen union power and enforce Wall Street regulations Dodd-Frank and a modern version of Glass-Steagall. Biden's climate targets (re-enter the Paris Climate Agreement, carbon-free electricity by 2035 and non-zero emissions by 2050) will benefit companies within climate and clean energy but make life harder for coal and oil. Like Trump, Biden proposes "Made in America" tax credits (10%) and "Buy American" clauses for federal contracts.

Expansive fiscal policy, less trade drama

However, we also believe a Biden presidency will mean more expansive fiscal policy, more than making up for proposed tax hikes. The Democrats' Covid-19 stimulus package, the Heroes Act (USD 3 trillion) is significantly larger than the Republican Heals Act (USD 1 trillion). The stalemate in stimulus talks means that part of this is likely to be implemented in 2021 instead, which, in case of a Biden victory, would include extended unemployment support and more support for states and local governments. The key part of the Biden agenda is a climate/green energy infrastructure spending plan of USD 2 trillion over four years (nearly 2.5% of GDP per year). Low resource utilization in the aftermath of the coronavirus crisis makes it easier to justify massive clean energy investments as part of a recovery policy. Relations with China will not improve given that mistrust of China is entrenched in both parties. However, Biden is less likely to pursue a bilateral trade war, preferring to work together with allies, and will prioritize domestic policies above trade agreements.

Control of Congress key

The ability of Trump or Biden to carry out their policies depends on their control of Congress. Republicans are unlikely to regain the House of Representatives. This supports the notion that trade policies, where the President is less dependent on Congress, will remain key for Trump. Biden may win the Senate but not a 60-vote super majority. This means that climate initiatives will likely need to be included in the budget, which only requires a simple majority.

EM portfolio flows

Gradual EM FX recovery due to subdued capital inflows

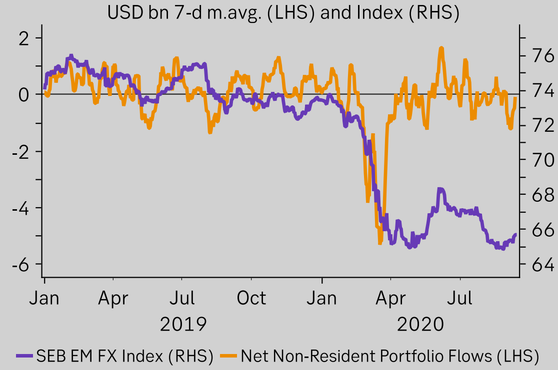
Emerging Markets look likely to receive net investment inflows in the coming 6 months, which will provide support for their currencies, especially in Asia where the economies are relatively less dependent on commodity production and exports compared to Africa and Latin America. In addition, demand destruction in several EM economies mean that current account deficits will narrow or reverse into surpluses with some notable exceptions such as Turkey. Nevertheless, a larger return of net capital inflows to EM is unlikely before a vaccine is available. As a result, a strong rally in EM FX is unlikely, thus pushing investors to be selective.

Non-resident portfolio investments in Emerging Markets (EM) registered the largest monthly net outflow on record in March 2020, according to data aggregated by the Institute of International Finance (IIF). Outflows during the global financial crisis in 2008 were larger but spread out over four months. In contrast, when it became clear to investors that Covid-19 would become a severe global pandemic, the withdrawal of capital from EM was large and sudden. Swift monetary policy easing and fiscal stimulus packages importantly in the US, EU and China helped stabilise flows already in April. Yet, compared to previous crises, the recovery in capital flows since then has been muted. While portfolio investment flows do not solely determine the direction of EM FX changes, muted flows have had a dampening effect on EM currencies over the past 4–5 months.

What is the outlook for capital flows to EM? We see three key reasons why flows have been subdued. First, massive monetary easing by EM central banks and weak demand for credit have pushed down interest rates to record lows in many EM countries. While EM debt spreads have narrowed after a sharp widening in March, they remain roughly 100bps wider than before the outbreak. Wider spreads should be supportive of capital flows into EM in an environment of rising risk appetite. However, with yields at record lows, spreads have not been wide enough to convince investors that EM is worth the risk, including debt sustainability and

Investment flows have stabilised at low levels

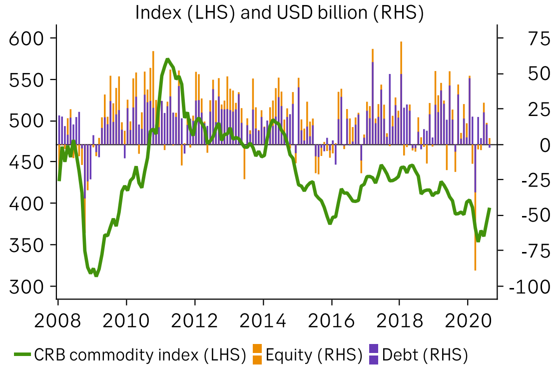
USD bn 7-d m.avg. (LHS) and Index (RHS)



Source: Institute of International Finance (IIF), Bloomberg, Macrobond, SEB rising inflation. Second, uncertainty about Covid-19 is very high. Most countries have eased restrictions on travel and economic activity since March and April thanks to falling infection rates. However, the risk of a new wave of infections is potentially high, which could prompt governments to reimpose quarantines and other social distancing measures. Third, while massive monetary stimulus in the US and euro area have lifted primarily tech stocks to record highs, most EM economies are more dependent on traditional heavy industries, commodity production and trade, which have been hard hit by the pandemic. Commodity prices have generally recovered losses since March, but prices were low before onset of the pandemic, reflecting a relatively feeble economic outlook. While China is providing stimulus to grow construction, it is nowhere near the scale after the GFC in 2008–2009 or the China growth scare in 2014–2015. The subdued outlook for commodities has kept a lid on investment inflows into EM assets and EM FX gains so far in 2020.

Portfolio flows waiting for commodity recovery

Index (LHS) and USD billion (RHS)



Source: Commodity Research Bureau (CRB), Bloomberg, Macrobond, SEB

We expect Beijing to continue to stimulate growth by easing monetary policy somewhat before the end of the year and by providing support for domestic demand, partly through increased construction. Yet, the stimulus will be incremental and not as large as after the previous slowdowns due to policymakers' concern about rising debt levels.

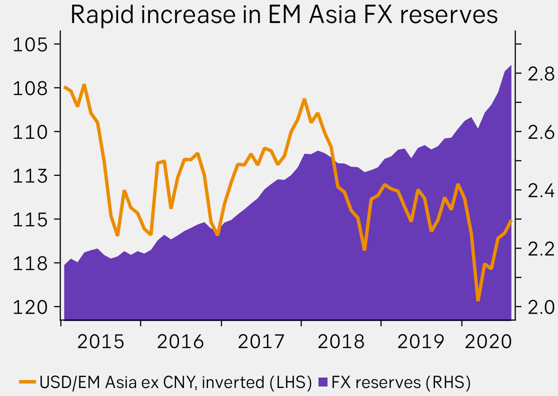
A new wave of strict and extensive lockdowns both in EM and developed markets is unlikely—which is supportive of EM risk appetite and capital flows to EM—given the additional economic damage that they would cause. Instead, governments will follow the Chinese example of limited regional or local lockdowns.

Lastly, when it comes to the outlook for yields in EM, they are likely to remain low at least until a vaccine is widely available, which for many EM countries may last well into 2021. Taken together, we expect capital flows to EM to be positive and to give some support for EM currencies, especially in Asia where the economies are relatively less dependent on commodity production and exports compared to Africa and Latin America. Nevertheless, a larger return of net capital inflows to EM is unlikely before a vaccine is available.

Weak dollar has benefitted EM Asian currencies. Since May, EM Asian currencies have gained between 0.8% and 3.8% against the greenback. However, most currencies in the region have yet to regain fully their losses since the outbreak of the pandemic. Idiosyncratic factors have led to varying degrees of recovery among the currencies. The Philippine peso is leading the pack. Stringent mobility restrictions capped domestic demand and imports leading to a significant improvement in the current account. Meanwhile, the Indonesian rupiah is lagging with foreign investors cautious of the central bank's public debt monetization. **Overall, we expect EM Asian currencies to continue to strengthen in the next 6–12 months even if the greenback were to consolidate.**

Constant presence of Asian central banks limited FX gains. FX reserves across EM Asia-ex- China reached a fresh record high of more than USD2.8 trillion in August (Chart 1). The experience of the Asian Financial Crisis has ingrained in policymakers the importance of maintaining ample FX reserves as a defence against capital outflows. Reserves broadly declined in March when central banks stepped in to limit volatility amidst the deep sell off. Since then, Asian central banks, except in China and Malaysia, have resumed a build-up of reserves. Using the IMF's reserve adequacy metrics, Asian central banks hold more than enough reserves, with some now holding excessive levels of foreign currency assets, in our view.

Rapid increase in EM Asia FX reserves



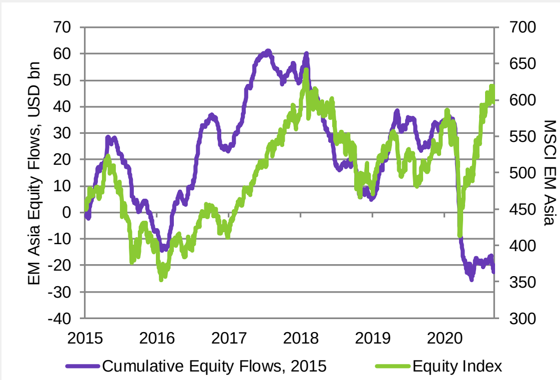
Source: Bloomberg, SEB

Threat of US censure may prod Asia's central banks to ease aggressive FX interventions. Persistent one-sided FX intervention is a criterion for ending up on the US Treasury's Monitoring List. Although ample reserves lower the economy's risk premium and lends more stability, the US Treasury keeps a close eye on Asian central banks. In its last report released in January, five out of the ten economies on the Monitoring List are from EM Asia (China, South Korea, Singapore, Malaysia and Vietnam). Based on latest reserves data, India, Taiwan and Thailand are now at risk of being added to the list. Since being removed from the list in 2019, India has been the most active in FX intervention. India's FX reserves at USD541 billion are now the fifth largest in the world. The increase of USD66 billion in the last five months occurred even when the INR had not been under great appreciation pressures.

Light foreign positioning favours more appreciation in EM Asian currencies. In the four months to May, foreign equity outflows reached almost USD62 billion, approximately two years' worth of inflows (Chart 2).

Since then, flows are slowly turning positive led by foreign equity into China and India. Even so, foreign equity investment remains far from pre-pandemic levels. As such, foreign investors largely missed the gains in the EM Asian equity markets. Considering the massive increase in global liquidity by major central banks, it is only a matter of time before foreign flows return to the region.

Portfolio flows have barely returned to EM Asia since the sell-off in March.



Source: Bloomberg, SEB

Fundamentals provide a sanguine environment for EM Asian currencies. The lockdowns imposed in Q2 led to deeper-than-expected contractions across the region. High frequency data and alternative mobility indicators indicate that recovery is underway. A continued rise in new infections in India and Indonesia, coupled with new outbreaks in other economies, is keeping the growth outlook uncertain. Even so, we believe that the nadir in GDP growth has passed. As long as governments are able to manage the spread of the virus without resorting back to nationwide lockdowns, the economies can remain on the path to recovery.

Improvement in external balances is supportive of EM Asian currencies. Although exports plunged when demand declined among Asia's main trading partners, imports collapsed faster. More stringent lockdowns in Asia choked off domestic demand leading to a significant improvement in trade balances. The dual deficit economies (India, Indonesia, and the Philippines) posted the biggest improvement. India may have at least 2 quarters of current account surplus, while the Philippines is likely to post an annual current account surplus in 2020. Moreover, the expected recovery in global demand will likely usher in a recovery in global trade.

Positioning

Short USD positioning saturated, FX exposure is still very light

Analyzing positioning data, we have found that all three investigated speculative categories during the summer have build-up short USD holdings. These are now quite large in a historical perspective and we thus expect a period with a partial downscaling which would support the USD. Based on the positioning data it is also obvious that FX exposure, which was cut severely early in the Covid-19 crisis, remains very low.

Being an over-the-counter market the true positioning of participants in the currency market is not possible to gauge. Yet positioning is an important piece of information when forecasting exchange rates. We have analyzed three different proxies each focusing on different investor categories to provide some information on how the market may be positioned. We have analyzed (1) systematic trend-followers (e.g. CTAs), (2) leveraged funds (e.g. macro hedge funds), and (3) a broad category of investors (e.g. asset managers) using three separate data sources: SEB Dashboard, CFTC's TFF report and CFTS's COT report[1].

From long to short USD positioning during summer

The development in the aggregated G10 vs USD positioning has been quite similar for all three investor categories during the summer: a switch from a net long USD into a net short USD position. However, this fresh long USD position also looks saturated for all the categories and over the last two weeks there have been indications that they have begun to trim the long USD position slightly. We believe this may continue for a few more weeks which would lend support to the USD for some time before long-term factors once again begin to dominate and lead to more USD weakness.

FX exposure remains very low

The amount of held contracts both among leveraged funds (TFF report) and investors in general (COT report) remains very low compared with levels just before the breakout of the Covid-19 crisis. It has recovered some from lows but has a long way to go before there is more normal liquidity in currency markets again.

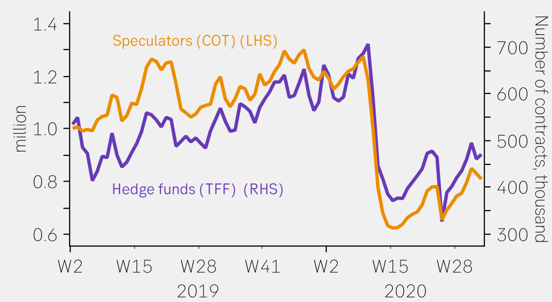
Long EUR positioning stands out

Looking at the different G10 currencies it is long positioning in the EUR that mostly looks saturated. This can be seen in the charts on the next page.

CAD and GBP a bit different

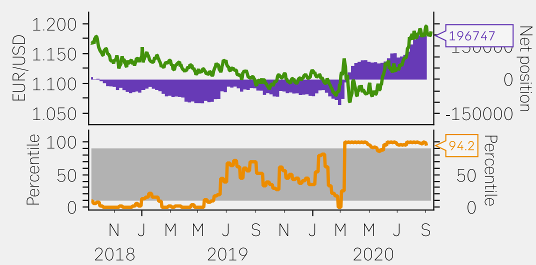
Positioning in the CAD and GBP differs a bit from the general G10 norm. Both leveraged funds and speculators in general are short the CAD vs the USD and are even shorter than they tend to be (i.e. compared with a one-year average). The GBP does not stand out in the CFTC data, i.e. investors are long GBP vs USD and more so than on average lately, but it does stand out among CTAs as the currency they are least long vs the USD and where they really have slashed a previously large long GBP position. This is on the back of GBP weakness due to Brexit negotiations, so it clearly has a fundamental explanation. The lack of support for the CAD is trickier but could have to do with the close connection between Canada and the US or bearish oil views. Nevertheless, in a positioning perspective the CAD position does not look saturated as the other G10 currencies.

FX exposure based on number of contracts held

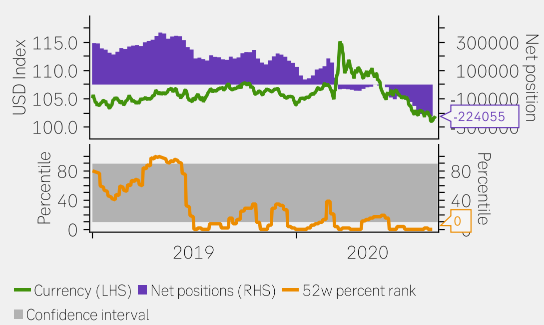


Source: CFTC COT and TFF, SEB

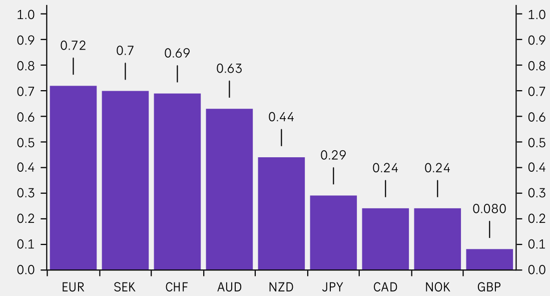
EUR/USD broad investors net position – largest ever!



USD aggregated vs G10

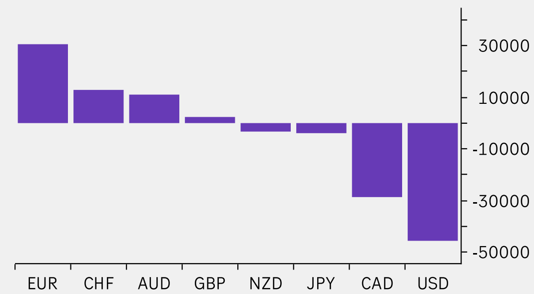


Trend-follower positioning (ccy vs USD, strength of signal and thus expected size of position)



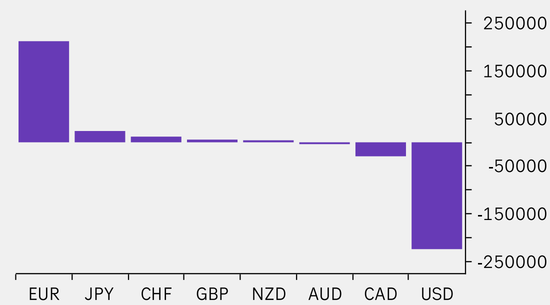
Source: Macrobond, SEB

Leveraged funds positioning (ccy vs USD, net position)



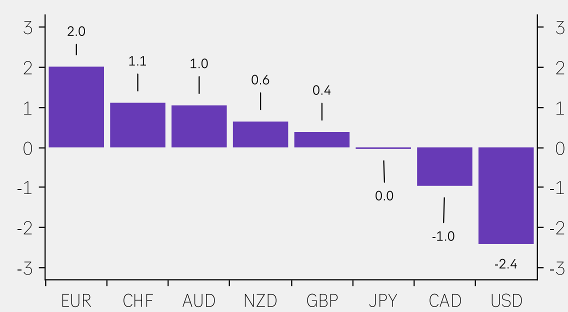
Source: Commodity Futures Trading Commission (CFTC) TFF report, Macrobond, SEB

Broad investor positioning (ccy vs USD, net position)



Source: Commodity Futures Trading Commission (CFTC) COT report, Macrobond, SEB

Leveraged funds deviation from norm (ccy vs USD, st dev)



Source: Commodity Futures Trading Commission (CFTC) TFF report, Macrobond, SEB

1. SEB Dashboard estimates positioning based on a model replicating common systematic trend-follower strategies.

CFTC's TFF report is a weekly sum up of what traders of financial futures have done with currency futures. We have chosen the category leveraged fund to look at.

CFTC's COT report is a weekly sum up of the commitment of traders i.e. what traders have done during the week with currency futures. We analyze data from the specified category speculative accounts i.e. commercial hedgers are not included.

Commodity Futures Trading Commission's (CFTC) COT and TFF reports are frequently used as proxies for positioning in the currency markets.

Q4 seasonality

Strong patterns but seasonality has been overshadowed in 2020

Most currency pairs have seasonal patterns which tend to be the largest around the shift of years. In Q4, lower NOK/SEK and higher EUR/NOK stand out, while on a monthly basis higher EUR/SEK in October and lower in December stand out.

Q4

Going back 10 years shows patterns in some currencies, but in general patterns are more robust when focusing on the past eight years – i.e. since 2012. What stands out in this period is NOK/SEK (which in Q4 has fallen for seven straight years), EUR/NOK (which had risen for six straight years before last year), USD/CAD (which before last year had risen seven years in a row), and finally USD/JPY (which has risen in seven of the past eight years).

October

EUR/SEK tends to head higher in October. It has done so in nine of the past 10 years, but the pattern goes back further: EUR/SEK has risen in October since 2003 with only two exceptions (2006 and 2011). For the past 10 years the average rise has been 1.0% but has been smaller over the past two years (0.5% 2018 and 0.4% 2019).

November

USD/CAD and NOK/SEK stand out in November. USD/CAD has risen seven straight years and nine out of the past 10 years by an average of 0.9% while NOK/SEK has fallen the past seven years and nine out of the past 19 years by an average of 1.2%. Also, higher USD/JPY is common in November.

December

Lower EUR/CHF, EUR/SEK, and NOK/SEK is common the last month of the year. The most robust of these are lower EUR/SEK which has been a bit tricky in the past as it usually has headed higher in the beginning of the month ahead of yearly pension related SEK outflows, only to turn for the lower after these and end the month on the whole lower. The pension related rise has however been more muted lately which is why the main pattern is for EUR/SEK to fall in December. It has done so for five straight years and nine of the last 10 years and by an average of 0.9%. NOK/SEK has been nearly as robust falling eight out of the past 10 years, but it deviated from this pattern last year.

Q4 seasonality

Q4 seasonality (% quarterly change)

	EURCHF	EURGBP	**EURNOK**	EURSEK	EURUSD	**USDCAD**	**USDJPY**	USDCNY	**NOKSEK**
2010	-6.9	-1.2	-2.9	-2.2	-1.9	-3.1	-2.9	-1.4	0.8
2011	0.1	-3.0	-1.4	-3.0	-3.2	-2.6	-0.2	-0.8	-1.5
2012	-0.1	2.1	-0.2	1.6	2.6	1.1	10.9	-0.9	2.0
2013	0.3	-0.7	2.5	1.5	1.6	3.0	6.9	-1.1	-0.9
2014	-0.4	-0.4	10.6	3.6	-4.3	3.6	8.6	1.0	-6.9
2015	0.0	-0.2	0.9	-1.9	-2.9	3.9	0.3	2.2	-2.7
2016	-1.6	-1.7	1.2	-0.6	-6.6	2.4	14.3	3.6	-1.7
2017	2.3	0.6	4.6	2.2	1.6	0.8	0.2	-2.2	-2.5
2018	-0.9	0.7	4.9	-1.6	-1.3	5.9	-3.7	0.2	-6.5
2019	-0.2	-4.8	-0.5	-2.1	2.9	-1.9	0.5	-2.4	-1.7
10 years: % rising	30	30	60	40	40	70	70	40	20
% falling	70	70	40	60	60	30	30	60	**80**
Average change (%)	-0.7	-0.9	**2.0**	-0.2	-1.2	**1.3**	**3.5**	-0.2	**-2.2**

October seasonality (% monthly change)

	EURCHF	EURGBP	EURNOK	**EURSEK**	EURUSD	USDCAD	USDJPY	**USDCNY**	NOKSEK
2010	2.3	0.2	1.8	1.2	2.3	-1.0	-3.8	-0.3	-0.6
2011	0.0	0.3	-2.0	-2.0	3.4	-4.7	1.4	-0.1	0.2
2012	-0.1	1.0	0.4	1.8	0.8	1.7	2.3	-0.8	1.4
2013	0.6	1.3	-0.8	1.2	0.4	1.2	0.1	-0.5	2.0
2014	0.0	0.5	4.1	1.6	-0.8	0.6	2.4	-0.4	-2.5
2015	-0.1	-3.5	-1.9	0.4	-1.5	-1.8	0.6	-0.6	2.4
2016	-0.4	3.3	1.0	3.0	-2.3	2.2	3.4	1.1	2.0
2017	1.5	-0.7	1.2	1.4	-1.4	3.3	1.0	-0.3	0.4
2018	0.4	-0.5	1.0	0.5	-2.5	2.1	-0.6	1.1	-0.3
2019	1.1	-2.9	3.3	0.4	2.3	-0.6	0.0	-1.3	-3.0
% rising	60	60	70	**90**	50	60	70	20	60
% falling	40	40	30	10	50	40	30	**80**	40
Average change (%)	0.5	-0.1	0.8	**1.0**	0.1	0.3	0.7	**-0.2**	0.2

November seasonality (% monthly change)

	EURCHF	EURGBP	EURNOK	EURSEK	EURUSD	**USDCAD**	**USDJPY**	USDCNY	**NOKSEK**
2010	-5.0	-4.1	-1.2	-1.9	-7.2	0.6	4.1	-0.2	-0.5
2011	1.0	-0.6	0.8	0.9	-3.0	1.6	-0.7	0.3	-0.1
2012	-0.2	0.9	-0.3	0.6	0.2	-0.5	3.3	-0.2	0.9
2013	0.0	-2.0	3.1	1.0	0.1	1.7	4.1	0.0	-2.1
2014	-0.3	1.6	3.5	0.2	-0.5	1.3	5.4	0.4	-3.3
2015	-0.1	-1.6	-1.7	-1.8	-4.2	2.1	2.0	1.3	-0.1
2016	-0.8	-5.8	-0.5	-1.5	-3.6	0.2	8.8	1.7	-1.0
2017	0.8	0.4	4.0	2.2	2.2	0.1	-1.0	-0.4	-1.8
2018	-0.9	0.1	2.2	-0.6	0.0	1.0	0.6	-0.1	-2.8
2019	0.2	-1.1	-0.9	-2.0	-1.2	0.9	1.3	-0.2	-1.3
% rising	30	40	50	50	40	**90**	**80**	50	10
% falling	70	60	50	50	60	10	20	50	**90**
Average change (%)	-0.5	-1.2	0.9	-0.3	-1.7	**0.9**	**2.8**	0.3	**-1.2**

December seasonality (% monthly change)

	EURCHF	EURGBP	EURNOK	**EURSEK**	EURUSD	USDCAD	USDJPY	USDCNY	**NOKSEK**
2010	-4.1	2.7	-3.4	-1.5	3.0	-2.8	-3.1	-0.9	1.9
2011	-0.9	-2.7	-0.2	-2.0	-3.7	0.4	-0.9	-1.1	-1.6
2012	0.2	0.1	-0.3	-0.8	1.6	-0.1	5.3	0.0	-0.3
2013	-0.3	-0.1	0.2	-0.8	1.1	0.1	2.8	-0.6	-0.8
2014	-0.1	-2.5	2.9	1.8	-2.9	1.7	0.9	1.0	-1.2
2015	0.1	4.9	4.5	-0.5	2.8	3.5	-2.4	1.5	-5.0
2016	-0.5	0.8	0.7	-2.1	-0.7	0.0	2.2	0.7	-2.7
2017	-0.1	0.9	-0.6	-1.4	0.8	-2.6	0.1	-1.6	-1.0
2018	-0.4	1.1	1.7	-1.5	1.2	2.8	-3.6	-0.7	-3.4
2019	-1.5	-0.8	-3.0	-0.5	1.8	-2.2	-0.8	-0.9	2.6
% rising	20	60	50	10	70	60	50	40	20
% falling	**80**	40	50	**90**	30	40	50	60	**80**
Average change (%)	**-0.8**	0.5	0.2	**-0.9**	0.5	0.1	0.0	-0.3	**-1.2**

Research contacts

Erica Dalstø
NOK
+47 2282 7277

Richard Falkenhäll
Editor, GBP, SEK
+46 8 506 23133

Ann Enshagen Lavebrink
Research Assistant
+ 46 8 763 80 77

Eugenia Fabon Victorino
CNY
Theme: EM portfolio flows
+65 6505 0583

Per Hammarlund
Theme: EM portfolio flows
+46 8 506 231 77

Carl Hammer
CHF, JPY
+ 46 8 506 231 28

Lauri Hälikkä
EUR, USD, CAD
+ 46 8 639 23 48

Elisabet Kopelman
Theme: US elections
+46 8 506 230 91

Karl Steiner
Theme: Positioning
Theme: Q4 seasonality
+46 8 506 231 04

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