Global Viewpoint

Issue No: 10/20

October 6, 2010

Goldman Sachs Global Economics,
Commodities and Strategy Research
at **https://360.gs.com**

New FX Forecasts: More Broad USD Weakness Ahead

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We are revising the majority of our FX forecasts to reflect broad Dollar depreciation. We have been emphasising for some time that structural US imbalances are the main reason for USD weakness and this remains our key theme. In the near term, a number of factors could still provide a boost for the Dollar, but these no longer form the base case for our 3-month forecasts. Instead, we expect the USD TWI to decline gradually from current levels, by about 4.7%, over the next 12 months and to get quite close to historical lows. Importantly, with USD weakness shared globally, the trade-weighted impact for other currencies would likely be relatively muted. Most other countries would experience relatively little appreciation. For example, the EUR TWI would only appreciate by about 3.9% from current levels, although we project EUR/$ at 1.55 in 12 months. Asia will play an important role and we now expect trade-weighted appreciation in key countries, such as China and Korea.

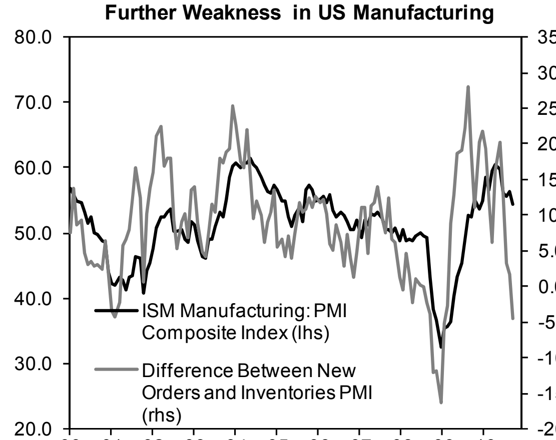
1. Dollar Weakness Is the Dominant Macro Theme Again

When we last changed our major currency forecasts in early July, we signalled two key drivers of FX markets. First, we expected slow growth and structural imbalances in the US economy to drive the USD lower in the medium term. Second, we assumed that cyclical slowing from peak Q2 Euro-zone growth rates and temporarily re-emerging sovereign concerns could boost the Dollar against the Euro in the short term.

Since we laid out this scenario, many factors have played out as assumed. After an initial rally during the quiet summer months, EUR/$ dropped back by about 5% in late August and early September. Growth momentum in Europe is now in the process of slowing, as indicated by the latest round of PMIs. Moreover, re-emerging sovereign concerns and deteriorating risk sentiment were additional factors. Markets have focused on strikes across Europe at the same time as a number of governments announced additional fiscal tightening measures to keep their budget consolidation plans on track. Sovereign spreads have widened again, at least in parts of the periphery.

However, and contrary to our expectations, markets did not focus on these issues as sharply or for as long as they did in Spring. As a consequence, EUR/$ stabilised slightly above 1.26 and did not quite make it to our 3-month forecast of 1.22.

ISM Orders-Inventories Gap Points to Further Weakness in US Manufacturing



Source: Haver Analytics

This was partly due to the more idiosyncratic nature of the renewed tensions and the growing ability of investors to isolate issues. As Francesco Garzarelli has argued, the existence of the European Financial Stability Facility (EFSF) as a backstop has substantially reduced the fear of broader contagion, and in many cases there have been genuine improvements in the fiscal outlook. Portugal, Ireland and France have all announced additional tightening measures in the past few weeks, and this steady drip of positive policy news has helped build confidence in the evolving Euro-zone fiscal framework and prevented the latest sovereign jitters from being treated as systemic.

More importantly, the US macro outlook has deteriorated even faster than expected, as is possibly best illustrated by the new orders less inventory gap in the manufacturing ISM (see chart on previous page). In August, we revised down our US growth views and predicted a shift back towards QE2. Since then, the Fed has implicitly strengthened the commitment to low rates by stating more concretely that it would like to see inflation move higher—and markets now firmly expect additional quantitative easing, encouraged by continued specific commentary from senior Fed officials. Against this backdrop, we have seen a rapid shift to broad USD weakness over the past month. In contrast, most other countries (Japan is the main exception given the policy initiatives at the recent BoJ meeting) show little sign of heading in this direction, reinforcing our confidence in the divergence between growth and policy paths between the US and much of the rest of the world, which has been a lynchpin of our more negative medium-term view on the USD.

At the same time US policymakers have turned up the volume on FX-related issues and put a lot more pressure on Asia in particular. Of course, this has to be seen in the context of the imminent mid-term elections and the near 10% unemployment rate, which itself has been influenced by years of manufacturing relocation to Asia. The fact that the US trade balance has deteriorated notably in recent months makes the political case for USD depreciation even stronger.

The combination of weaker growth, more QE, FX policy pressure on Asia for more currency appreciation and widening external imbalances all point in the same direction: broad USD weakness. And this is likely to remain the dominant theme.

2. Recap of Dollar Fundamentals

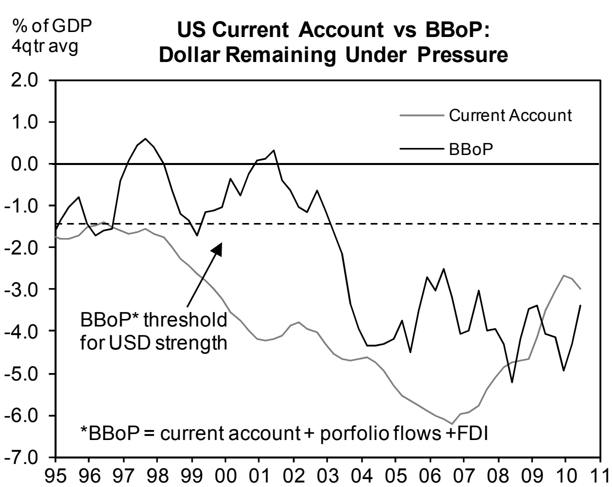
In the September issue of the *Global FX Monthly Analyst*, we discussed the macro factors at the core of our USD-bearish views. We expect the US economy to grow substantially below trend over the next 12 months and in 2011 as a whole. This expected weakness remains directly linked to a number of persistent structural imbalances, which in some cases have started to deteriorate again. In particular, the following points have caught our attention:

Persistent high unemployment is a particular feature of the current US problems, hinting at a large output gap. It reflects the need to reallocate considerable economic resources from artificially inflated sectors (in particular, real-estate-related). A shift of a sizeable part of the labour force from one sector to another takes time.

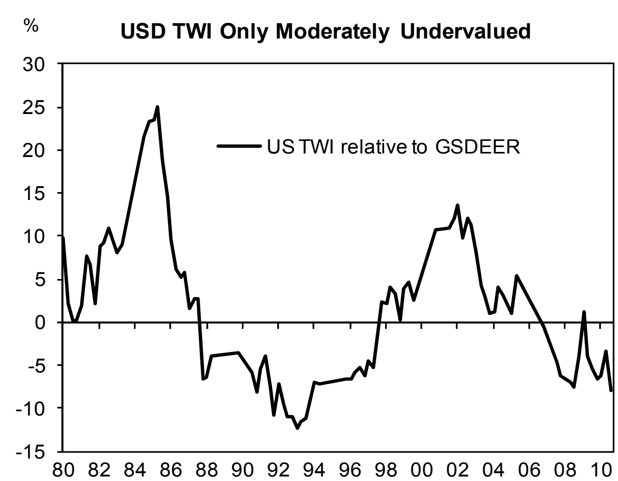
The US household savings rate remains too low relative to the US's own long-run history, international comparisons and the demographic situation. As savings rise, the unusually high share of consumption in GDP will likely decline.

Import demand has picked up strongly during the inventory cycle, highlighting just how little the US economy has rebalanced and how much US demand seems to depend on foreign supply. Relocating production to the US is a slow process and it could take many years.

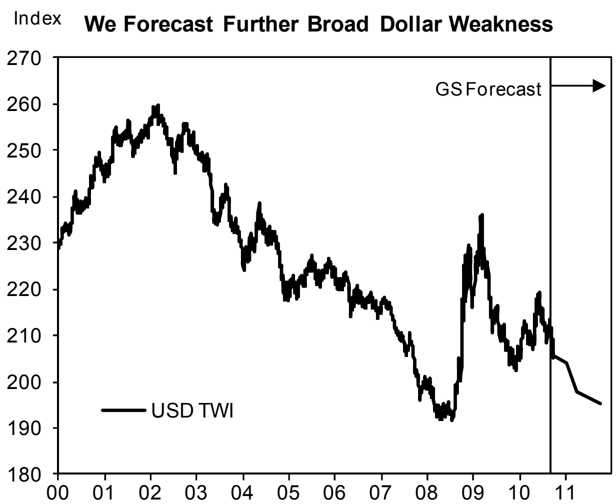
Rate differentials have moved sharply against the USD as markets have increasingly priced in our long-held sluggish US growth scenario. Expectations of renewed quantitative easing in the US suggest rate differentials are unlikely to boost the USD anytime soon. On the other hand, stronger growth outside the US, in a positive



Source: Haver Analytics, National Source, GS Global ECS Research



Source: GS Global ECS Research



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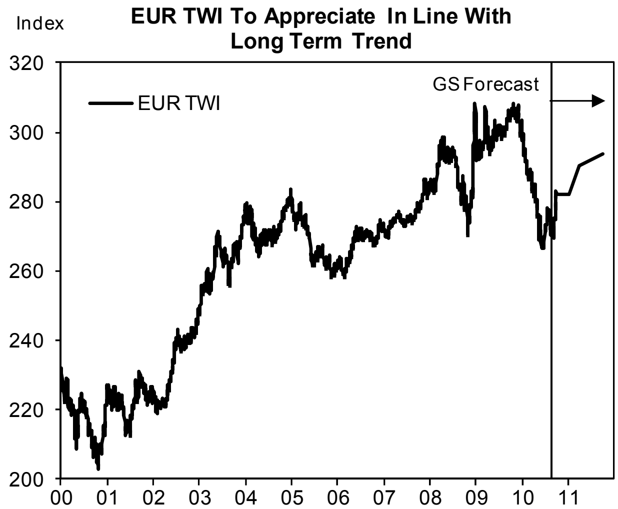

Source: GS Global ECS Research

decoupling scenario, would likely weaken the USD via a corresponding shift in rate differentials. We continue to forecast wider rate spreads to the US in almost all of the G10 than the market currently prices even now.

Lastly, **fiscal consolidation** needs in the US are among the most important globally and on many measures, including from the IMF, the adjustment need in the US is comparable to that in the UK, Spain and Greece—and only slightly smaller than the fiscal adjustment required in Japan. Tighter fiscal policy will add to the outlook for slowing final demand in the US, a potentially USD-negative development.

Overall, the macro outlook is sufficiently challenging to make the US one of the least popular investment destinations currently. For example, the last 11 consecutive quarters of FDI data have shown a net outflow. This capital outflow/lack of inflow, together with continued trade deficits, helps drive the Dollar down. Our private-sector BBoP (current account + net FDI + portfolio flows) continues to illustrate this point well.

The resulting USD weakness should eventually help the US become more competitive and boost the domestic economy relative to the rest of the world—but that is only likely to occur well beyond our regular 12-month forecasting horizon. For now the USD has to become increasingly undervalued on a TWI basis, specifically to support this process of re-balancing the US economy. The trade-weighted Dollar is currently about 8% undervalued on our GSDEER model, which is still relatively modest relative to the peak misalignments of 13%-30% in previous cycles.

3. Global Patterns of Projected USD Weakness

What will this broad USD weakness mean for others? Given that the USD is the base currency in a number of FX crosses, it is easy to miss the fact that most currencies will appreciate a lot less in trade-weighted terms than the USD will weaken. For example, our new forecasts project EUR/$ at 1.55 in 12 months' time (13% in bilateral terms from current levels); together with all other forecast changes (see table), this translates into a 4.7% trade-weighted USD weakness from current levels. At the same time, the trade-weighted EUR will only strengthen by about 3.9% because we expect key Euro-zone trading partners also to witness USD weakness—and most of the EUR crosses remain relatively more stable.

Moreover, whereas the trade-weighted USD is likely to approach record lows in 12 months, the EUR TWI will probably only end up in the middle of the range of the last couple of years, about 6% below the highs.

One of the reasons why we do not see even more USD TWI weakness is that we are reluctant to project much additional strength in the MXN and CAD. Together they account for 30% of US trade and so they could directly suffer from the structural challenges facing the US.

Of course, EM currencies—and Asian ones in particular—play a large role in the USD TWI and the degree to which they continue to attempt to resist appreciation pressure, as some have done lately, will be important for the overall currency shifts in the US and elsewhere. Although we think many currencies will continue to cushion some of that pressure, we expect bilateral appreciation against the USD to continue here too.

That move is likely to have more than just a bilateral flavour in some key currencies, as the comfort with (and necessity of) allowing some appreciation gathers. In Asia, the trade-weighted CNY will likely appreciate by about 2.0% and the KRW TWI strengthen by 2.4%. This is important to highlight, as we expect Asia to participate in the broad Dollar move—a contrast to the past, when Asian currencies often still recorded some trade-weighted weakness on the back of a broader USD down move. Clearly the political developments highlighted at the beginning are a major driver of this new dynamic and an important feature of our global USD projections. But continued steady growth in Asia should help here too.

Forecasts for Nominal GS TWIs

Jan 1980=100	Year Average				Latest	Forecasts			Percentage Change		
	2006	2007	2008	2009	04-Oct-10	3m	6m	12m	3m	6m	12m
US Dollar	218.7	208.5	202.2	215.5	205.3	204.1	198.2	195.8	-0.6	-3.5	-4.7
Japanese Yen	343.7	326.4	367.7	420.8	450.3	456.0	448.4	421.7	1.3	-0.4	-6.3
Euro	267.7	276.2	288.2	300.5	282.1	280.9	289.3	293.1	-0.4	2.6	3.9
Swiss Franc	149.5	145.2	153.5	162.7	179.6	183.9	186.8	184.2	2.4	4.0	2.5
British Pound	100.8	102.7	90.1	80.5	80.0	82.4	84.2	85.0	3.0	5.3	6.3
Swedish Krona	64.3	65.0	63.9	59.3	65.8	67.3	69.5	69.8	2.2	5.6	6.0
Norwegian Kroner	88.6	90.1	91.0	88.3	92.2	95.6	96.6	98.4	3.8	4.9	6.8
Canadian Dollar	113.1	118.1	117.4	111.8	122.6	121.0	123.5	125.4	-1.3	0.7	2.2
Australian Dollar	71.8	76.7	75.2	71.8	82.8	83.9	84.6	85.4	1.3	2.2	3.1
New Zealand Dollar	72.7	78.2	73.4	67.6	73.3	72.4	71.5	71.3	-1.3	-2.6	-2.8
Chinese Yuan	21.7	21.9	23.6	25.1	24.1	24.2	24.0	24.6	0.3	-0.4	2.0
Korean Won	56.9	56.6	46.4	40.0	43.2	43.3	42.6	44.2	0.3	-1.2	2.4
Indian Rupee	22.4	23.6	21.8	20.3	21.0	20.9	20.7	20.5	-1.9	-3.4	-5.1
Mexican Peso	0.25	0.24	0.24	0.20	0.21	0.20	0.20	0.20	-0.6	-1.6	-2.2
Brazilian Real	0.26	0.28	0.29	0.29	0.33	0.32	0.30	0.29	-1.5	-7.7	-10.7

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New FX Forecasts

	New Forecasts			Old Forecasts		
	3m	6m	12m	3m	6m	12m
EUR/$	1.40	1.50	1.55	1.22	1.35	1.38
$/JPY	81.00	81.00	85.00	85.00	83.00	90.00
EUR/JPY	113.40	121.50	131.75	103.70	112.05	124.20
GBP/$**	1.67	1.79	1.85	1.45	1.61	1.64
EUR/SEK	9.00	8.80	8.80	9.40	9.20	9.00
EUR/CHF	1.30	1.30	1.33	1.27	1.30	1.33
EUR/CZK	24.55	24.55	24.50	24.80	24.80	24.60
EUR/HUF	275	280	280	285	285	285
EUR/PLN	3.90	3.87	3.77	4.00	3.90	3.77
$/RUB	29.50	28.00	27.50	30.50	29.50	27.50
$/TRY	1.38	1.30	1.27	1.55	1.45	1.37
$/ILS	3.50	3.30	3.25	3.80	3.55	3.48
$/ZAR	6.75	6.30	6.20	7.70	7.45	6.80
$/BRL	1.70	1.80	1.85	1.70	1.80	1.95
$/C$	1.03	1.00	0.98	1.03	1.03	1.00
$/CLP	470	470	480	495	495	505
A$/$	1.00	1.03	1.05	0.88	0.88	0.86
NZ$/$	0.75	0.76	0.77	0.74	0.74	0.70
$/CNY	6.56	6.49	6.29	6.74	6.66	6.49
$/INR*	44.00	43.40	43.00	47.50	44.00	43.00
$/KRW*	1100	1100	1050	1150	1100	1050
$/MYR	3.00	2.95	2.90	3.10	3.05	3.00
$/SGD	1.29	1.27	1.25	1.36	1.33	1.31
$/TWD	30.30	30.00	29.50	31.50	30.75	30.00
$/THB	30.00	29.50	29.30	32.00	31.20	31.00
$/IDR	8750	8600	8450	8800	8700	8500
$/PHP	43.00	42.00	41.00	44.50	44.00	43.00

*Forecast changes released since our last FX Mthly was published

**We have not changed EUR/GBP. Change in GBP/$ reflects change in EUR/$ forecasts

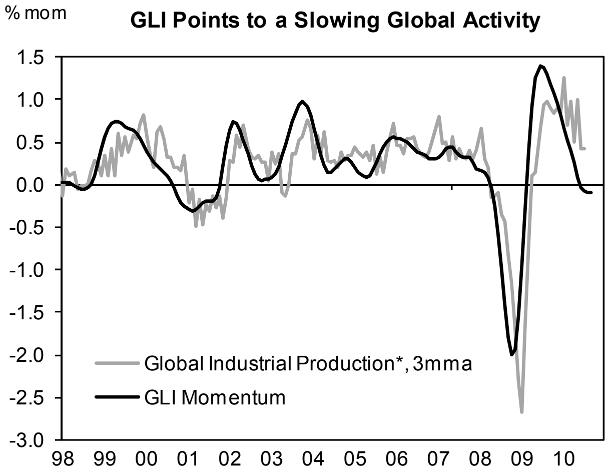
Source: GS Global ECS Research

A few currencies stand out as exceptions to this pattern, though. For example, we expect to see notable trade-weighted JPY weakness; in fact, even more than for the USD. This is because marginal $/JPY weakness from current levels should be more than offset by the notable appreciation of most other Asian currencies. However, this has to be seen in the context of the Yen already being exceptionally strong; hence the margin to participate further in broader USD weakness is limited.

The only cases where our forecasts point to notable trade-weighted appreciation are the SEK (+6.0%) and NOK (+6.8%), which remain strong peripheral growth stories, and the GBP (+6.3%), which we expect to remain notably undervalued relative to the EUR. The latter is likely to be somewhat controversial, given the hints of the need for more QE from some on the MPC. But we think the market has effectively already traded that view quite aggressively and, while we do see rate hikes coming later than before, we think the UK situation is different to that of the US, as last Friday's *UK Monthly Analyst* set out. In these countries, we could see somewhat less of the monetary tightening that is required coming through rate hikes than we currently expect, and somewhat more occurring through FX.

Still, the European peripheral currencies are the exception and the vast majority of countries will likely see relatively little trade-weighted appreciation compared with the USD depreciation in our forecasts.

The two tables show the actual forecasts, new versus old, as well as the projected trade-weighted path for the G10 and key EM currencies.



* Includes OECD countries plus BRICs, Indonesia and South Africa
Source: OECD, GS Global ECS Research

4. Some Short-Term Risks to Our USD Views Remain

Following the shifting focus on the US imbalances, the issues in Europe appear to have been pushed into the background. We fully agree with this market conclusion; throughout the European sovereign crisis we have consistently highlighted that the fundamental issues in the US would ultimately become the bigger issue for FX markets.

The Euro-zone as a whole is economically much more balanced than the US on pretty much any key measure relevant for FX markets, including current account, private-sector capital inflows, savings rates, foreign ownership of Government securities and average fiscal deficits. With that in mind, it appears possible to find a solution for most political coordination problems and much of the related heavy-lifting has already been achieved during the crisis in May/June.

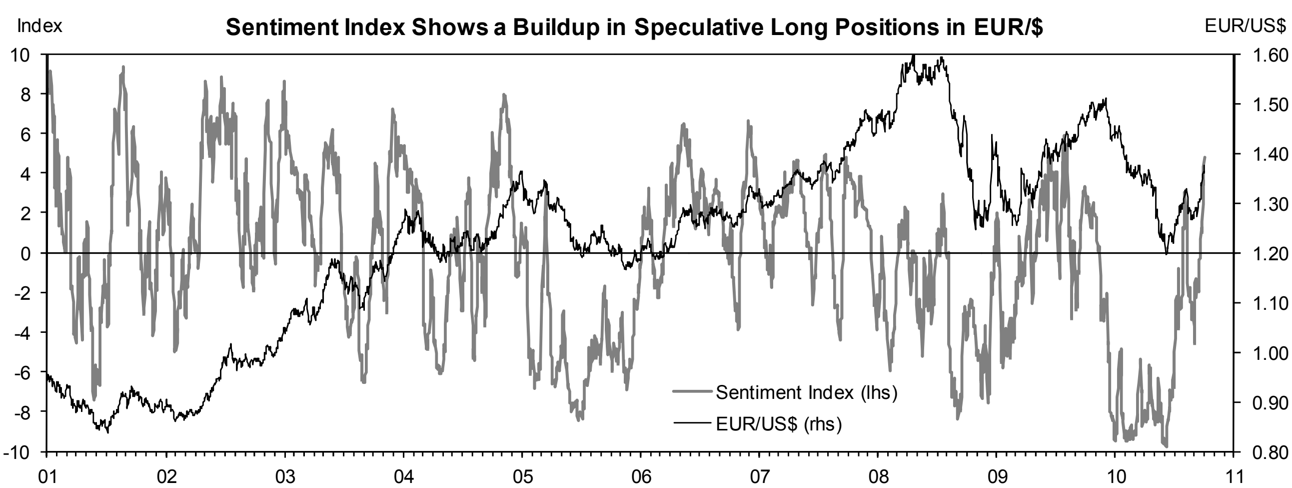
That said, it would be wrong to assume that all Euro-zone problems are solved and from an institutional point of view the EUR remains a bit of a 'homeless currency', as we discussed earlier in the year. The evolution of the Stability and Growth Pact (SGP) remains highly uncertain at the current junction and this includes the non-permanent nature of the EFSF. Some sovereign spreads remain wide; the outlook for Irish banks and fiscal policy looks shaky. And, lastly, a number of Euro-zone governments face low approval ratings, which could lead to more market-unfriendly friction.

Beyond the European sovereign issues, we see two additional risks to our new forecasts. First, global macro data remains mixed at best and many of the forward-looking indicators have continued to deteriorate. This is probably best illustrated via the negative momentum evident in our GLI (see chart). And this has also happened at a time when equity markets and other pro-cyclical assets have rallied notably. A temporary increase in risk aversion on the back of the unsettled macro picture remains within the range of possibilities and, given strong correlations with FX, this would likely boost the broad USD—at least temporarily.

Second, speculative positioning in EUR/$ is now at a level that could have been viewed as stretched 'long' in the last five years or so, at the same time as $/JPY positioning remains in 'short' territory. This creates unwinding risks for USD shorts. But again, this is not our base case, as a reversal of the situation in the first half of the year is still the more likely scenario, in our view. At the time, the EUR/$ Sentiment Index persistently stood at stretched 'short' levels, while the strong underlying down-trend was persistent. This time round, we may well see stretched 'longs' and a persistent up-trend.

All these short-term factors linked to positioning, risk correlations and remaining sovereign issues could temporarily boost the Dollar. As a result, we would not be surprised to see EUR/$ dip briefly below 1.30 in the next few weeks. Needless to say, with our 3-month forecasts well above those levels—and even beyond—we would see that kind of pullback as a significant opportunity.

Beyond the very near term, global Dollar weakness is our core conviction and base case. And this trend is likely to continue until a sufficient degree of USD undervaluation has been achieved to help adjust US imbalances.



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Exchange Rate Forecasts
Dollar Crosses

Dollar Based Forecasts

		3-Month Horizon		6-Month Horizon		12-Month Horizon		
	Current*	Forward	Forecast	Forward	Forecast	Forward	Forecast	5-Yr Forecast**
G3								
EUR/$	1.38	1.38	1.40	1.38	1.50	1.38	1.55	1.20
$/JPY	83.20	83.11	81.00	83.00	81.00	82.74	85.00	108.12
Europe								
£/$	1.59	1.59	1.67	1.59	1.79	1.59	1.85	1.55
$/NOK	5.82	5.85	5.50	5.87	5.13	5.93	4.90	6.25
$/SEK	6.69	6.71	6.43	6.73	5.87	6.78	5.68	7.12
$/CHF	0.97	0.97	0.93	0.96	0.87	0.96	0.86	1.23
$/CZK	17.70	17.72	17.54	17.74	16.37	17.77	15.81	19.54
$/HUF	194.55	196.57	196.43	198.51	186.67	202.32	180.65	233.30
$/PLN	2.85	2.87	2.79	2.89	2.58	2.93	2.43	2.96
$/RUB	30.04	30.25	29.50	30.50	28.00	31.16	27.50	30.00
$/TRY	1.43	1.45	1.38	1.47	1.30	1.52	1.27	1.80
$/ILS	3.61	3.61	3.50	3.62	3.30	3.64	3.25	4.07
$/ZAR	6.89	6.99	6.75	7.08	6.30	7.28	6.20	7.60
Americas								
$/ARS	3.96	4.04	4.05	4.12	4.15	4.36	4.30	4.50
$/BRL	1.67	1.70	1.70	1.74	1.80	1.81	1.85	2.71
$/C$	1.02	1.02	1.03	1.02	1.00	1.03	0.98	1.16
$/MXN	12.49	12.59	12.75	12.70	12.85	12.95	13.00	13.15
$/CLP	483	485	470	487	470	494	480	433
$/PEN	2.79	2.79	2.80	2.79	2.80	2.81	2.85	3.55
$/COP	1801	1803	1900	1807	1950	1832	2000	2173
$/VEF	4.29	na	4.30	na	4.30	na	4.30	5.00
Asia								
A$/$	0.97	0.96	1.00	0.95	1.03	0.93	1.05	0.79
$/CNY	6.69	6.62	6.56	6.58	6.49	6.50	6.29	5.85
$/HKD	7.76	7.75	7.80	7.75	7.80	7.74	7.80	7.80
$/INR	44.40	44.91	44.00	45.45	43.40	46.51	43.00	38.00
$/KRW	1124	1128	1100	1131	1100	1138	1050	975
$/MYR	3.09	3.10	3.00	3.11	2.95	3.13	2.90	2.73
NZ$/$	0.75	0.74	0.75	0.74	0.76	0.73	0.77	0.61
$/SGD	1.31	1.31	1.29	1.31	1.27	1.31	1.25	1.21
$/TWD	31.08	30.74	30.30	30.50	30.00	30.19	29.50	27.05
$/THB	30.11	30.13	30.00	30.16	29.50	30.24	29.30	34.89
$/IDR	8930	8997	8750	9087	8600	9330	8450	9569
$/PHP	43.60	43.95	43.00	44.24	42.00	44.73	41.00	40.00

* Close 05 October 10

**5Yr Forecasts have been discussed in Global View point 09/17 "The Rate Hike - Risk Sentiment Nexus".

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Exchange Rate Forecasts
Euro Crosses

Euro Based Forecasts

		3-Month Horizon		6-Month Horizon		12-Month Horizon		
	Current*	**Forward**	**Forecast**	**Forward**	**Forecast**	**Forward**	**Forecast**	**5-Yr Forecast****
G3								
EUR/$	1.38	1.38	1.40	1.38	1.50	1.38	1.55	1.20
EUR/JPY	115.20	115.01	113.40	114.76	121.50	114.18	131.75	129.7
Europe								
EUR/£	0.87	0.87	0.84	0.87	0.84	0.87	0.84	0.77
EUR/NOK	8.06	8.09	7.70	8.12	7.70	8.18	7.60	7.50
EUR/SEK	9.27	9.28	9.00	9.30	8.80	9.35	8.80	8.54
EUR/CHF	1.34	1.34	1.30	1.33	1.30	1.33	1.33	1.48
EUR/CZK	24.50	24.52	24.55	24.52	24.55	24.52	24.50	23.45
EUR/HUF	269.38	272.01	275.00	274.47	280.00	279.21	280.00	279.96
EUR/PLN	3.95	3.97	3.90	4.00	3.87	4.04	3.77	3.55
EUR/RUB	41.60	41.86	41.30	42.17	42.00	43.00	42.63	36.00
EUR/TRY	1.98	2.01	1.93	2.04	1.95	2.10	1.97	2.16
EUR/ILS	4.99	5.00	4.90	5.01	4.95	5.02	5.04	4.88
EUR/ZAR	9.53	9.67	9.45	9.79	9.45	10.05	9.61	9.12
Americas								
EUR/ARS	5.48	5.58	5.67	5.70	6.23	6.01	6.67	5.40
EUR/BRL	2.32	2.36	2.38	2.40	2.70	2.50	2.87	3.25
EUR/C$	1.41	1.41	1.44	1.41	1.50	1.42	1.52	1.39
EUR/MXN	17.29	17.42	17.85	17.56	19.28	17.87	20.15	15.78
EUR/CLP	668.77	670.85	658.00	673.69	705.00	681.04	744.00	520.16
EUR/PEN	3.86	3.86	3.92	3.86	4.20	3.88	4.42	4.26
EUR/COP	2494	2495	2660	2498	2925	2528	3100	2608
EUR/VEF	11.76	na	6.02	na	6.45	na	6.67	6.00
Asia								
EUR/A$	1.43	1.44	1.40	1.46	1.46	1.49	1.48	1.52
EUR/CNY	9.26	9.16	9.18	9.09	9.74	8.97	9.75	7.02
EUR/HKD	10.74	10.73	10.92	10.72	11.70	10.69	12.09	9.36
EUR/INR	61.48	62.15	61.60	62.85	65.10	64.18	66.65	45.60
EUR/KRW	1556	1560	1540	1564	1650	1570	1628	1170
EUR/MYR	4.28	4.29	4.20	4.30	4.43	4.32	4.50	3.28
EUR/NZD	1.85	1.86	1.87	1.87	1.97	1.90	2.01	1.97
EUR/SGD	1.81	1.81	1.81	1.81	1.91	1.81	1.94	1.45
EUR/TWD	43.03	42.53	42.42	42.16	45.00	41.66	45.73	32.46
EUR/THB	41.69	41.69	42.00	41.70	44.25	41.72	45.42	41.87
EUR/IDR	12365	12450	12250	12564	12900	12876	13098	11483
EUR/PHP	60.37	60.82	60.20	61.17	63.00	61.73	63.55	48.00

* Close 05 October 10

**5Yr Forecasts have been discussed in Global View point 09/17 "The Rate Hike - Risk Sentiment Nexus".

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We, Thomas Stolper, Robin Brooks, Fiona Lake, Themistoklis Fiotakis, Mark Tan and Constantin Burgi, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.