Monex February 2022 **FX Forecasts**

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Introduction

FX volatility picked up in the second half of January as geopolitical risks mounted and rates markets began to adjust to expectations of more aggressive tightening cycles within the G10 space. The most disruptive repricing occurred in US rates after the January Federal Reserve meeting, which the US central bank used to set up a March rate hike following supportive labour market and inflation data. The surge in US rates reverberated across the G10 space, emboldening speculation of more aggressive tightening in other core rates markets. However, the more hawkish pricing across the G10 rates space as a whole did little to offset the dollar's rally as 2-year Treasury yields climbed to highs of 1.2% to mark a 50bps rise in January. As measured by the 30-day annualised standard deviation move in the DXY index, volatility in the broad dollar reached highs last seen in early December, during the arrival of the Omicron variant towards the end of January as markets adjusted to a steeper US rate profile.

Despite the level of volatility in FX markets and the dollar's rally towards the latter part of the month, our near-term January forecasts remained accurate. This was due to the marginal bullish adjustment in our USD forecasts at the start of the year and the lower USD base from where the dollar rally commenced mid-month. Outside of the Federal Reserve, January saw the Bank of Canada defy our expectations of a 25bps rate hike, with the Bank instead opting to use the meeting to signal lift-off in March, and December's CPI data from the UK confirm that the Bank of England is set to conduct back-to-back rate hikes in February for the first time since 2004. In Turkey, the lira continued its recovery despite a stark increase in the Bank's inflation forecasts as rates remained on hold and further prudential measures were announced to promote "Liraization". Across the G10 as a whole, EM currencies that provide high carry and value performed the best against the Fed-fuelled dollar, while G10 currencies as a whole remained subject to the dollar pressure.

> Looking ahead, we expect the **dollar's strength to be more nuanced in February** and for it to be isolated against currencies where rates are likely to lag the rise in US rates.

In our forecasts, this largely pertains to EUR, JPY and CNY. However, against other currencies, we expect the dollar to start weakening at the margin as the adjustment in US rates markets stabilise around the 5 rate hike outlook currently priced in. An improvement in global growth conditions, coupled with easing pressure on equities and risk appetite from the rates space, should facilitate a mild rally in risk sensitive currencies, at least in the interim until the focus resumes on the Fed ahead of March's meeting and refreshed projections. With respect to volatility in the FX space, we expect it to remain above last year's averages as adjustments in rates markets persist. Amid this environment, we have opted to forecast mean values for some currencies in the short-term, such as EURUSD, where we deem risks to be fairly balanced.

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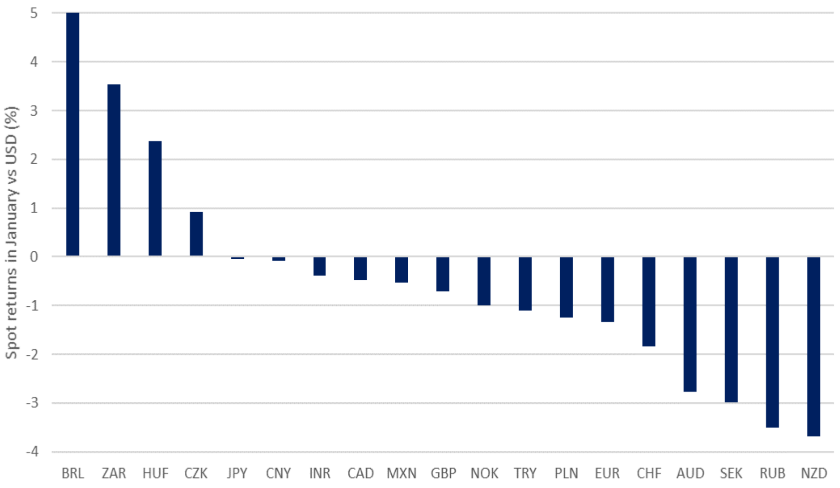
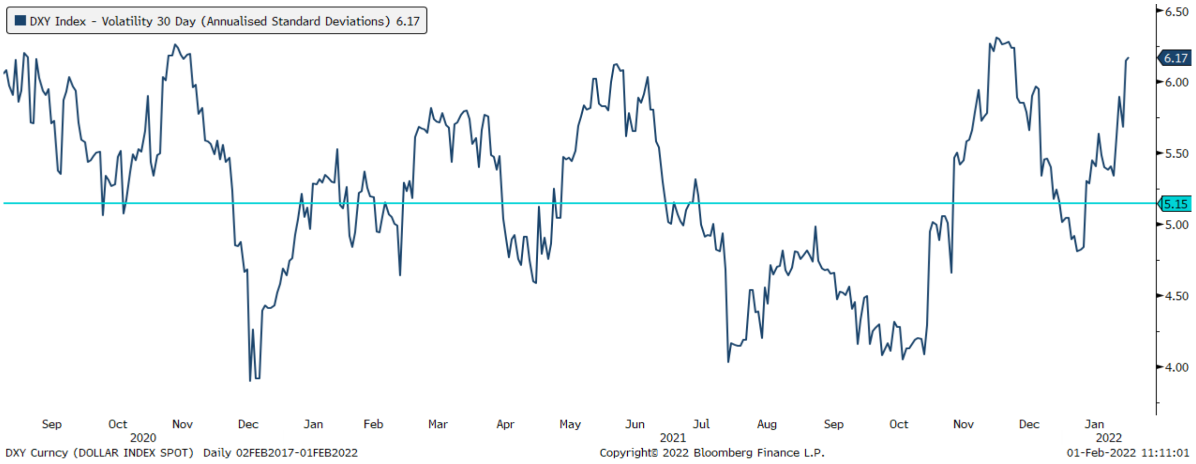
G10 and EM returns vs USD in January



Volatility in the broad dollar sat above 2021's average for the whole of January and spiked in the final fortnight of the month



DXY

Our expectation of a slightly stronger dollar due to more hawkish expectations for the Federal Reserve played out over the course of January, with the DXY marginally overshooting our 1-month forecast of 96.09 as it closed the month out at 96.52. Developments over the course of January - notably the Fed's December meeting minutes, employment and inflation data, and Chair Powell's commentary at January's meeting – has resulted in us bringing forward our expectations of rate lift-off in the US.

"We now expect the Fed to raise rates by 25bps at March's meeting, while there is a substantial risk that median rate forecast in the March dot plot is revised up from three to four rate hikes."

However, given the adjustment in front-end rates and with OIS markets now pricing in five rate hikes this year from the Fed, we think further upside in the dollar is limited the near-term. Over the medium-term, improvements in global growth conditions, rising rates in the rest of the G10 space, and disinflationary dynamics should result in mild USD depreciation, especially against high beta currencies. We continue to expect a "two-speed" dollar within the G10 space over this time horizon.

EUR

The rise in European political risk and US Treasury yields in January made EURUSD an easy target within the G10. The euro, being more sensitive to yield differentials with the US, fell from highs of 1.1482 to lows of 1.1121 against the dollar in the two weeks around the Fed's January meeting. In response to the pressure from higher US yields, we have adjusted our one-month and three-month calls lower as we still expect the ECB to push back on market pricing of eurozone rates in H1. However, we don't deem it necessary to revise our longer-term calls lower without a further increase in intermediate Treasury yields, which would require clear signs of further hawkish adjustments to the markets' current Fed expectations.

> Therefore, we continue to believe that an improvement in global growth conditions will still be more deterministic for EURUSD in H2.

Downside risks to our forecasts include further significant increases in US Treasury yields, heightened inflation fears in the eurozone if the Russia-Ukraine situation leads to EU gas supply being used as a means of retaliating against sanctions, and extended lockdown measures in parts of the eurozone. Upside risks centre around the broadening of inflation pressures in the eurozone, which will encourage ECB policymakers to speed up policy normalisation, and signs of disinflationary pressures in the US that would result in less hawkish market pricing of US rates.

GBP

Our bullish 1M view on the pound over the course of January generated one of the larger forecast errors, as expectations of BoE hiking didn't shield GBP from rising US rates as effectively as we previously estimated. Additionally, increased political pressure added to the bearish sentiment seen over the course of the month. However, our core view on the pound remains unchanged. Given the limited upside in the near-term for US rate expectations and the likelihood of further hawkish commentary from the BoE at February's meeting, along with a 25bps hike and the start of quantitative tightening as per our base case, we expect the pound's rally to take place against USD over the course of the next month. Additionally, should the BoE meet our expectations, the stark divergence in BoE and ECB policy should drive EURGBP to fresh lows over the course of the month.

CHF

The recent decline in EURCHF to lows last seen in 2015 following Russia-Ukraine tensions, uncertainties around Italy's presidential elections, and ongoing European concerns around inflation and energy supplies, brought back concerns around currency intervention by the Swiss National Bank. While EURCHF has recovered from those six-year lows somewhat in the last few days following a more supportive risk backdrop and increased expectations of policy tightening by the ECB, we expect the 1.035 level will continue to be tested by markets as geopolitical tensions remain prominent and the ECB pushes back on market expectations for the time being. However, if the pressure on inflation doesn't ease in the eurozone and the ECB is forced to follow in the footsteps of the Fed and BoE, downwards pressure on EURCHF is likely to be released. Given the currency cross has plateaued around the 1.035 level, suggesting market hesitancy about SNB intervention at these levels, it will likely take a substantial deterioration in eurozone economic conditions or the regional risk profile to prompt a breakout to the downside.

CNY

Price action in the Chinese yuan towards the end of January compounds our view that narrowing rate differentials are likely to result in a structural depreciation in the yuan against the dollar. While in the near-term, capital flows are likely to mitigate the impact of rate differentials, and hence our more conservative 1-month call, we continue to expect the yuan to slowly depreciate over the course of the next 12-months.

RUB

Over the past month, the ruble has taken on water as tensions between Russia and Ukraine resulted in renewed sanction risk for Russian assets. While we outlined the risk of sanctions in previous RUB outlooks, this has not only materialised, but has become more detrimental to the currency given the more aggressive and wide-ranging level of sanctions that are currently being discussed. The most stringent measure would be to cut off Russia from the SWIFT global payments system, however, this isn't a light decision to take given the global political and financial instability risks that could arise. While this is not the baseline scenario markets are expecting (more targeted sanctions at banks and individuals are more likely), the possibility of Russia being cut off from SWIFT does pose a major downside risk to our RUB forecasts.

> Meanwhile, ongoing negotiations and the potential for a peace pact would see **sentiment around Russian assets** dramatically improve and would likely result in an aggressive retracement in **USDRUB** to December's range.

BRL

The Brazilian real has been a notable performer over the course of January in the face higher US rates and a stronger dollar more generally. A firm commitment by the BCB to tackle persistently high inflation with higher rates, combined with FX intervention via swap markets and bullish price action in industrial metals, have provided a supportive backdrop for BRL bulls. In reference to this, and our expectation of a stabilisation in USD pressure on EMFX in February, we expect a continued rally in the Brazilian real should the BCB meet market expectations and hike by 125bps in February.

> Over the medium-term, however, our view on the real turns less constructive as **political pressure in the run-up to October's election** will likely weigh on investor sentiment.

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Currency Pair	1-month (28th Feb 2022)	3-month (30th Apr 2022)	6-month (31st Jul 2022)	12-month (31st Jan 2023)
G10				
EUR/USD	1.12	1.1150	1.13	1.14
USD/JPY	115	116	115	115
GBP/USD	1.355	1.360	1.380	1.390
USD/CHF	0.924	0.933	0.930	0.939
USD/CAD	1.2650	1.25	1.24	1.23
AUD/USD	0.71	0.72	0.74	0.75
NZD/USD	0.67	0.69	0.72	0.72
USD/SEK	9.24	9.33	9.03	8.86
USD/NOK	8.84	8.97	8.67	8.60
DXY	96.61	96.90	95.66	94.99
Emerging Markets				
USD/CNY	6.38	6.40	6.42	6.50
USD/INR	75	75	74	73
USD/ZAR	15.5	15.8	15.0	15.5
USD/TRY	13	13	12.5	12.5
USD/RUB	76	75	72	72
USD/PLN	4.11	4.08	3.98	3.91
USD/HUF	321	327	323	316
USD/CZK	21.96	21.52	21.68	21.93
USD/BRL	5.2	5.3	5.8	5.7
USD/MXN	21	21.5	21	20.5
Euro Crosses				
EUR/GBP	0.827	0.820	0.819	0.820
EUR/CHF	1.0350	1.04	1.05	1.07
EUR/CAD	1.42	1.39	1.40	1.40
EUR/SEK	10.35	10.40	10.20	10.10
EUR/NOK	9.9	10	9.8	9.8
EUR/TRY	14.56	14.50	14.13	14.25
EUR/RUB	85.12	83.63	81.36	82.08
EUR/PLN	4.60	4.55	4.50	4.46
EUR/HUF	360	365	365	360
EUR/CZK	24.6	24	24.5	25
EUR/BRL	5.82	5.91	6.55	6.50
EUR/MXN	23.52	23.97	23.73	23.37