



Monex July 2022 **FX Forecasts**

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Introduction

The FX rollercoaster ride continued in June as traders attempted to balance the risk of higher inflation and central bank policy rates against growing recession fears in major economies like the US, the eurozone, and the UK. Ultimately, the mixture of tighter global financial conditions and lower growth expectations prompted inflows into the US dollar, resulting in the DXY index reversing course following a period of depreciation from mid-May. While the dollar's inflows were initially driven by price action in USDJPY and EURUSD, the two highest-weighted currency pairs within the DXY index, those inflows were soon extended by expectations of a more hawkish path for US interest rates.

On June 8th, the USDJPY rate soared above 134 for the first time in twenty years, sparking renewed concerns that the Bank of Japan could intervene in FX markets to support the Yen. While this had little initial bearing on the broad dollar, the effect of the yen's depreciation on wider market pricing was compounded the day after as the hawkish European Central Bank meeting caused peripheral bond spreads in Europe to widen and EURUSD to drop 0.9%.

Ultimately, the combination of both **euro and yen weakness** prompted the start of a **surge in the broad dollar**.

It was then the turn of May's US CPI report, which at 8.6% YoY nullified speculation that US inflation had peaked in April. The elevated pace of sequential price growth in the US, along with the broadening of price pressures into stickier components, prompted speculation that the Fed would hike rates more than the signalled 50bp increment. As rates markets began to price more aggressive action from the Federal Reserve, the dollar's climb higher extended across the board. Uncertainty over whether the Fed would hike by 50 or 75bps was soon put to bed by a Nick Timiraos article in the Wall Street Journal, which passed on the message from a Federal Reserve insider that the FOMC was set to hike rates by 75bps.

Two days after the WSJ leak, the Fed followed through on a 75bp hike, citing the findings from May's CPI report and the increase in longer-term inflation expectations to justify a more front-loaded policy path.

Not only did the Fed hike rates by 75bps, but they also presented a dot plot forecast in which the policy rate ends the year in the region of 3 to 3.5%, suggesting a second 75bp hike is the likeliest option for the FOMC at the July meeting and confirming market pricing of year-end and terminal interest rates. While the central bank decision initially pushed the broad dollar index to hit a new peak of 105.79, the more conservative tone that Chair Powell took in the press conference on growth conditions, along with his affirmation that a reversion to 50bp moves is possible as early as July, led the dollar to moderate thereafter.

With the Fed confirming the market outlook for US rates, the focus shifted back to growth concerns. While this resulted in pricing of the Fed's terminal rate being lowered and pulled forward, it also weighed on global commodity benchmarks, which lowered inflation expectations. Ultimately this limited how high Treasury yields could reach, thus capping the dollar's upside potential. During this period, the DXY index fluctuated around a mean value of 104.50.



Despite the combination of lower Treasury yields and heightened growth concerns, however, USDJPY continued to trade around multi-decade highs.



We believe that for USDJPY to retrace below the 130 handle, as per our June forecasts, markets need to see the risk of a US recession climb even higher, weighing on global equities, or for mounting inflation pressures to force a more hawkish pivot by the Bank of Japan away from its ultra-loose policy stance.

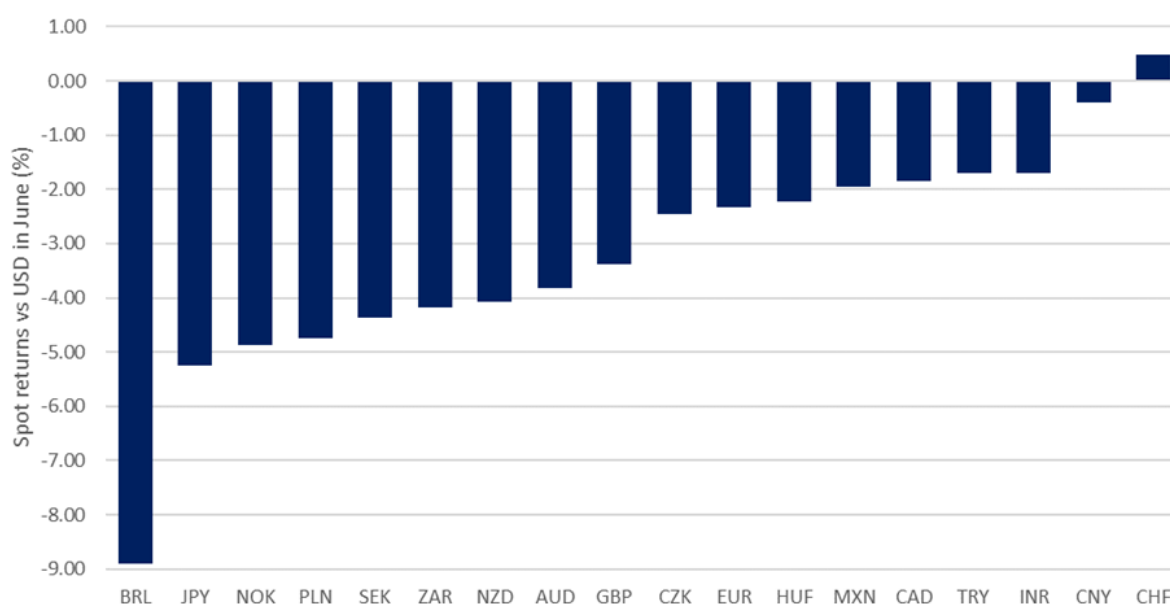
Outside the US, developments in other major central banks were plentiful in June. Generally speaking, 50bp hikes have become the norm, especially among the central banks that initially chose to look through the rise in inflation. At the start of the month, the Bank of Canada raised its overnight policy rate by 50bps to 1.5%, with the Reserve Bank of Australia following suit and bringing the Cash Rate 50bps higher to 0.85%. Meanwhile, the European Central Bank started to float the idea of going 50bps as early as September's meeting, but data and commentary since suggest that a larger hike could come earlier at July's meeting instead of the currently signalled 25bp move. Shortly after the Fed meeting, the central bank of Brazil slowed its hiking cycle, delivering a 50bp increase to bring the Selic rate to 13.25%, while the next morning, the Swiss National Bank publicly announced their new target for a stronger real effective CHF rate after they unexpectedly hiked their policy rate to 0.25%. Amid the growing 50bp theme, the Bank of England stood apart from the crowd as it voted 6-3 to hike rates by a mere 25bps. At the other end of the spectrum sat CE-3 central banks, who raised their interest rates by an average of 125bps in June as they tackled rising inflation and currency devaluation stemming from geopolitical turmoil.



While we anticipated in our June projections that hawkish messaging from Fed officials was set to continue, the increase in the pace of tightening and the higher projected terminal rate relative to our expectations resulted in a stronger dollar than we had forecast.

In response to developments over the past month, we continue to think that the US dollar is ripe for a downward adjustment, but we now expect this to occur in late Q3 following the Fed's September meeting, with downside risks for the dollar more prevalent in the fourth quarter.

The dollar appreciated against the bulk of the majors, with commodity and low-yielding currencies feeling the most pressure



Our thoughts on DXY, EUR, CAD, CHF and LatAm

DXY

As we noted above, the broad dollar continued its year-to-date trend in June, appreciating against most G10 currencies. With the Fed set to compound its recent decision with another 75bp increase at the July 27th meeting, we think the combination of higher US rates and global growth concerns warrants defensive dollar positioning over the coming quarter. Following the July meeting, however, we expect the Fed to slow the pace of its hiking cycle as the Fed funds rate reaches the middle of the central bank's estimated neutral range and pressure from energy markets on headline inflation moderates. In this regard, the September 21st Fed meeting should prove decisive for the broad dollar. Our current base case sees the Fed hiking rates by a further 50bp at that meeting, bringing the upper bound of its target range to 3%—the top of the estimated neutral range. Nonetheless, we expect the next iteration of the dot plot to remain unchanged for 2022 and be potentially revised lower for 2023. This would all but confirm that the Fed's hiking cycle is nearing its peak toward year-end, with policy expected to take a more data-dependent and fine-tuning approach. By then, we expect US growth

conditions to deteriorate further as tighter financial conditions continue to weigh on demand, while stronger disinflationary effects should also emerge. Accordingly, we have revised the timing of our call for a downward readjustment in the dollar, which we now expect in Q4. Some upside risks to our dollar forecasts remain and largely depend on the persistence of inflation given senior FOMC officials' public stance that they are prepared to tackle inflation even at the cost of growth.

EUR

With economic momentum starting to turn in the eurozone as reopening momentum fades, the ECB has a narrow window to hike rates before growth conditions restrict further monetary tightening. Reflecting this and the recent surge in euro-area CPI that threatens to further de-anchor inflation expectations, we believe the ECB will opt to hike interest rates by 50bps at their July meeting. The decision to do so will not only narrow interest rate differentials with the US, but is likely to prompt further capital inflows as the deposit rate rapidly exits negative territory for the first time in eight years. Despite our expectation of broad USD strength over the majority of Q3, we think the ECB's decision to raise rates more aggressively than is currently priced by markets will see the euro continue to trade at the midpoint of its recent range. Although we still hold a constructive view on EURUSD, we are not discounting the probability of the pair hitting parity over the coming months due to a deterioration in the supply of energy, especially in Germany.

CAD

Over the coming quarter, we expect the Canadian dollar to continue trading on a weaker footing against the US dollar as tighter global financial conditions sustain a tentative global risk backdrop. Amid this environment, we expect a continuation in equity drawdowns, coupled with growth risks weighing on commodity benchmarks, to maintain pressure on the Canadian dollar in the near-term. However, the rise in USDCAD is set to be limited by narrow US-Canada yield spreads as Bank of Canada officials maintain their commitment to keep pace with the Fed's tightening cycle for at least the next few meetings.



Heading into 2023, we expect USDCAD to return below the 1.30 handle as risk assets go bid on a probable loosening in financial conditions.

Oil and base metals prices will be a counterweight, as they are likely to give back some of their gains over the next year, but the loonie has been more heavily influenced by equity prices than commodities in recent months.

CHF

The Swiss National Bank's latest policy decision to actively target a stronger real exchange rate and hike rates by 50bps has seen the EURCHF pair fall below parity in recent days. In our June forecasts, we did not anticipate such actions by the SNB prior to their September meeting. Owing to this earlier-than-expected policy action, we have brought forward our expectation of EURCHF trading consistently below parity. Additionally, given the SNB's commitment to intervene in FX markets to achieve a stronger real CHF and the recent uptick in eurozone inflation, we have revised down our medium-term EURCHF forecast.

LatAm

Increased global growth concerns and a hawkish adjustment in US rates have driven a divergence among LatAm currencies in June. Previously favoured carry currencies, such as CLP and BRL, have sold off substantially against the dollar as a more hawkish path for US rates compressed yield differentials, while growth concerns eroded the previous positive terms-of-trade influences. Despite the broad sell-off in LatAm currencies, the Mexican peso has been a notable source of stability. Although the peso is historically sensitive to rising US rates, the earlier action taken by Banxico and their ability to move in lockstep with the Fed has meant that the downturn in US equities is having less of an impact on MXN this tightening cycle. Meanwhile, a strong flow of remittances and the shortening of US supply chains from China to Mexico is adding to the constructive outlook for the peso. We believe these positive developments will keep the USDMXN rate relatively stable over the current quarter despite our broader expectation of a risk-off climate in global markets..

Over the medium-term, we think a more **supportive global risk backdrop** and **higher Mexican interest rates** will drive appreciation in the **peso**

Comparatively, both domestic and external developments over the course of June have turned us substantially more bearish on BRL. The main development over the past month has been the downturn in global growth conditions and the contraction in manufacturing output, which is set to weigh on Brazil's terms-of-trade profile. Having been one of the main driving forces behind the real's appreciation over the past six months, especially since the onset of war in Ukraine, falling iron ore and crude oil prices are set to pose major headwinds to the real over the second half of the year. Additionally, the recent hawkish shift by the Federal Reserve has further compressed Brazil's yield differential, especially once factoring in CDS premiums. Finally, on a domestic level, the Brazilian real's tendency to depreciate in the run-up to Presidential elections due to increased political and fiscal uncertainty will likely add further upward pressure on the USDBRL rate over the coming months. The next Brazilian general election is scheduled for October 2nd, and until that date, preliminary polling data are likely to drive any idiosyncratic divergences between BRL and other LatAm currencies. Following the election, domestic

risk should abate, and combined with our expectation for broad dollar weakness, BRL should begin to appreciate once again. This is visible in our 6 and 12-month forecasts, which see USDBRL returning back to 5.25 and 5.00.

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Forecasts

Currency Pair	1-month 31 st July 2022)	3-month (30 th Sept 2022)	6-month (31 st Dec 2022)	12-month (30 th June 2023)
G10				
EUR/USD	1.06	1.06	1.10	1.14
USD/JPY	138	132	128	125
GBP/USD	1.19	1.19	1.22	1.26
USD/CHF	0.943	0.925	0.886	0.868
USD/CAD	1.30	1.30	1.28	1.26
AUD/USD	0.69	0.72	0.73	0.75
NZD/USD	0.62	0.64	0.65	0.68
USD/SEK	10.38	10.19	9.45	8.95
USD/NOK	9.91	9.81	9.09	8.68
DXY	104.67	103.88	100.35	97.18
Emerging Markets				
USD/CNY	6.7	6.7	6.6	6.5
USD/INR	79	79	76	75
USD/ZAR	16.5	16.8	16	15.5
USD/TRY	17	17	18	18
USD/PLN	4.48	4.43	4.23	4.04
USD/HUF	382	387	364	333
USD/CZK	23.3	23.1	22.3	21.9
USD/BRL	5.5	5.8	5.25	5.00
USD/MXN	20.5	20	19.5	19
Euro Crosses				
EUR/GBP	0.891	0.891	0.902	0.905
GBP/EUR	1.12	1.12	1.11	1.11
EUR/CHF	1.00	0.98	0.975	0.99
EUR/CAD	1.378	1.378	1.408	1.436
EUR/SEK	11.0	10.8	10.4	10.2
EUR/NOK	10.5	10.4	10.0	9.9
EUR/TRY	18.02	18.02	19.80	20.52
EUR/PLN	4.75	4.70	4.65	4.60
EUR/HUF	405	410	400	380
EUR/CZK	24.7	24.5	24.5	25
EUR/BRL	5.80	6.15	5.78	5.70
EUR/MXN	21.7	21.2	21.45	21.7