Monex May 2022 **FX Forecasts**

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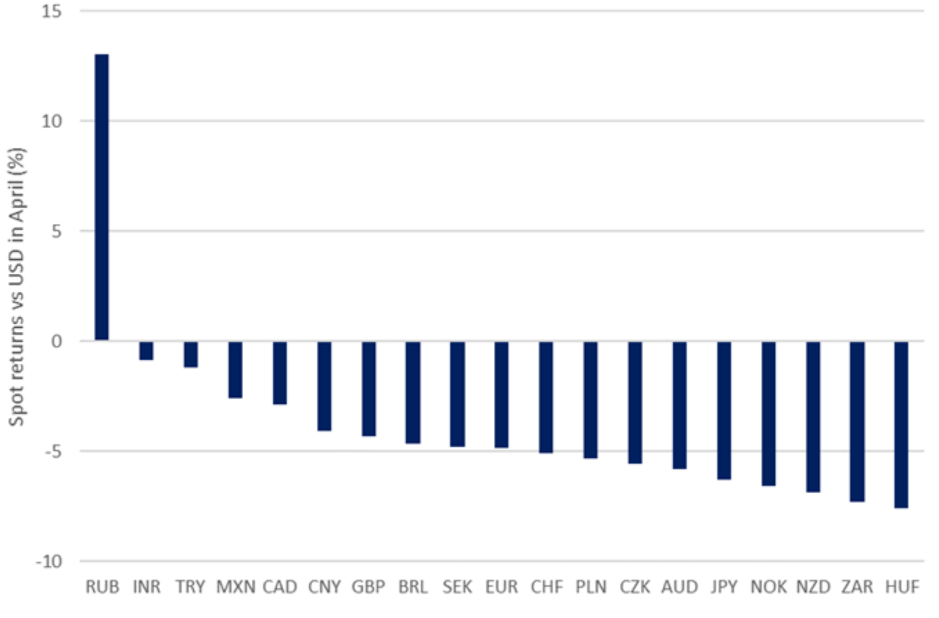
Introduction

While cross-asset volatility has been relatively high over the past month, a large proportion of this has been driven by fluctuations in bond markets, where concerns over global growth and inflation conditions are most visible. At the end of April, the ICE Bank of America MOVE index, which measures the implied volatility in bond markets for the next month, climbed close to the peak seen in early March after the onset of war in Ukraine. For further context, at 130, the current level of the MOVE index is just 10 points short of levels last seen during the onset of the pandemic. At that point, bond market volatility was so disruptive that central banks decided to directly intervene, buying assets in the open market to improve market functioning. This time around, bond market volatility hasn't risen solely on central banks' expected responses to the latest inflation shock caused by the Ukraine war, but also growth risks in major economies such as China and the eurozone. With recession risks rising over the medium-term, monetary policy is hard to pre-determine. And then, even when the policy moves are largely expected by fixed income markets, the corresponding FX impact hasn't been straightforward, as highlighted by the divergence in market reactions for CAD and NZD back on April 13th after both central banks hiked by 50bps, meeting expectations. The gyrations in bond market pricing have been influential for FX markets given that interest rate differentials continue to be the dominant driver of FX price action. However, it is not just rate differentials that have resulted in a stronger dollar over the course of April, but spikes in broader market volatility. Amid these uncertain conditions, the dollar's safe haven attributes are acutely visible, especially in the context of a stronger US economic backdrop and a perceivably more hawkish Federal Reserve. This has resulted in not only a 5-year high in the DXY index, which can skew the represented performance of the dollar due to its narrow composition, but a stronger dollar across the expanded majors space over the course of April.

Spot returns in the expanded majors vs US dollar over April

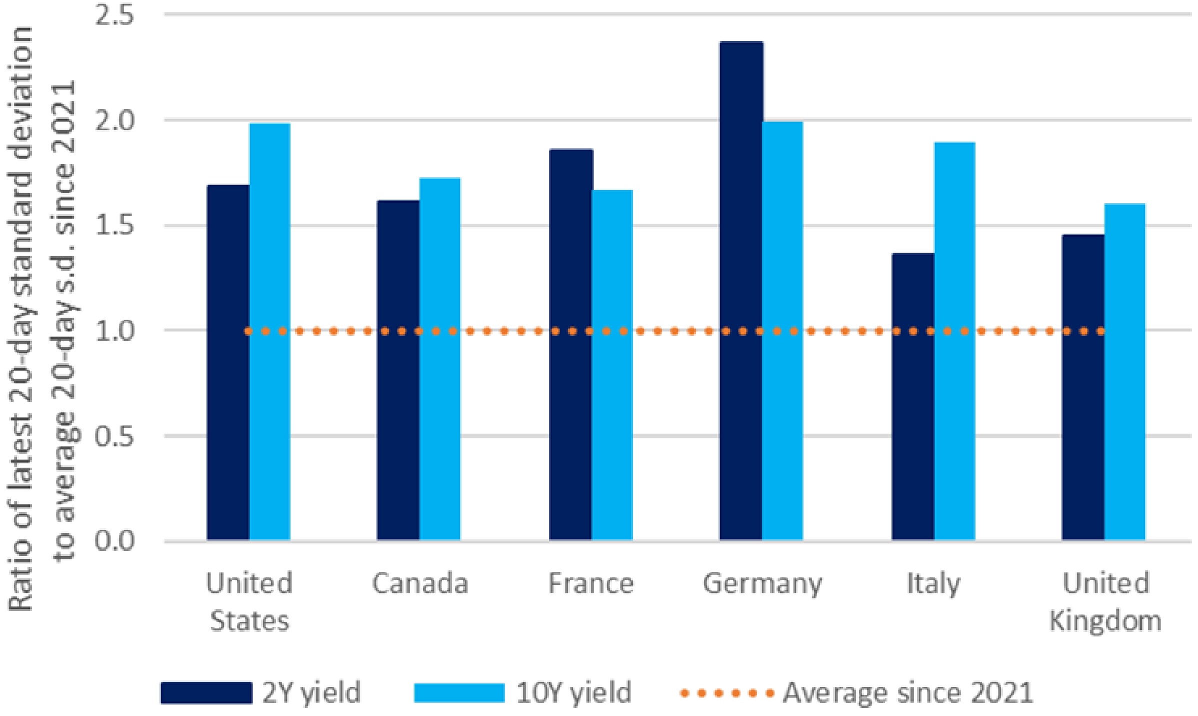


In response to these developments, we have marked our April forecasts to market. Our latest projections now reflect our most up-to-date expectations of central bank policy paths, which still deviate substantially from money market pricing outside of the US, capture increased growth risks, and also build in our assessment of what is perceived "risk premia" that has been priced into higher beta currencies.

Broadly speaking, over the course of the next week, **rate decisions** from the **Federal Reserve, Bank of England** and **Reserve Bank of Australia** should give markets more insight into how central banks aim to tackle the **slowing growth and high inflation environment at present.**

This should determine the trends in FX markets over the coming month. While we believe there remains scope for a dovish repricing in G10 money market instruments, especially for H2, we expect most of the FX impact will derive from bond market pricing instead, where pricing is more representative of central bank communications and the likeliest policy paths. In the near-term, given the increased level of uncertainty over the global macroeconomic backdrop, we expect recent dollar strength to persist before a stabilisation in market volatility and a reduction in inflation pressures in H2 result in the greenback trimming gains.

Realised volatility in global bond markets since April 1 has been far higher than usual



EUR

While President Macron's re-election removed a tail risk for the euro, it failed to alleviate bearish pressure on EURUSD as other drivers such as the war in Ukraine, the uncertain supply of natural gas, and the perceived risk of a global recession continued to weigh on the region's macroeconomic backdrop. With growth concerns in the region high and confidence measures plummeting as the precarious growth backdrop coincides with rising inflation pressures, we expect near-term pressure on the cyclically sensitive EUR to persist, especially once reopening effects start to drop out from incoming economic activity data. In addition to this, further drawdowns in European equities, upward pressure in global commodity benchmarks, and rising US rates suggest further downside in EURUSD is likely. Comparatively, with the euro currently trading at levels last seen in 2017, we don't expect a dovish repricing of the ECB's tightening path in money markets to result in further EUR depreciation, however.

While we foresee further EUR depreciation in the near-term, we expect the single currency to rebound in the second half of the year on the halting of persistent capital outflows and reduced growth risks. From a monetary policy perspective, the task for the ECB will be finding the right window to hike: too early, and deteriorating growth conditions will limit the extent to which the ECB can hike in the future, while too late and the disinflationary pressures that are due to naturally arise will make hiking rates a harder sell. Current conditions lead us to believe that the ECB will hike rates by 25bps at their July meeting after the conclusion of their Asset Purchase Programme. The shift in monetary regimes should end persistent capital outflows and coupled with reduced perceived growth risks in H2 2022, lead to a EURUSD retracement back up to the 1.0750-1.0950 range.

Expectations of a structurally weaker dollar over the medium-term reinforce our expectations of sustained EUR appreciation in the 6-to-12-month horizon.

JPY

The Japanese yen continued its aggressive depreciation over the course of March, breaking through our previous forecast of 122 as interest rate differentials continued to weigh on the currency. Above 125, the probability of the Bank of Japan intervening in FX markets materially increased, with verbal intervention ramping up as USDJPY edged closer to the 130 handle. Verbal measures seemed to have done the trick towards the end of April, halting the yen's freefall until the Bank of Japan meeting on April 28th triggered renewed JPY depreciation. By keeping policy on hold and committing to buy an unlimited amount of 10-year Japanese government bonds at 0.25%, the Bank of Japan failed to offer FX traders at least some concessions to stem the JPY rout, which resulted in the pair breaking above the 130 handle for the first time in twenty years. Risks of BoJ intervention are substantially higher now that Japan's exchange rate exceeds 130.

However, it is the pace of depreciation, not nominal levels, that concerns officials in our view. Given our expectation that real yield differentials are set to widen over the near-term, we expect JPY depreciation to persist, albeit at a slower pace as markets are fully aware of the intervention risk. Additionally, rising recession risks should keep the yen fairly well bid at current levels due to its safe haven appeal. Over the medium-term, a stabilisation in US rates and the increased likelihood that the BoJ starts to partially tighten policy should return USDJPY back below the 130 level.

GBP

Despite a brief spike in mid-April, money market expectations for the BoE's May meeting have remained stable over the past month. Markets currently expect a 25bp hike as their base case, and price a 20% chance of 50bps. This is despite the rising risks to the growth outlook and dovish commentary from the likes of external Monetary Policy Committee member Catherine Mann, who said that firms will be unable to pass on cost pressures if shrinking real incomes halt consumption growth, making inflation less persistent and higher rates less necessary. Instead, the more visible repricing of rate expectations due to rising growth risks has occurred in Gilt markets. The UK 2-year yield recently moderated from highs of 1.776% to 1.58% at the end of April, while the 10-year yield also fell back to 1.9% after a brief spell above 2%. Even then, the moderation in UK yields only occurred in the final week of April, and the overall change on the month has largely been negligible. This suggests that GBPUSD has somewhat disconnected from the rates space after the pair logged month-to-date returns of -4.3%. This disconnect suggests to us that a more aggressive dovish repricing of the Bank of England over the medium-term should have less consequences for FX markets, as money markets would be merely realigning with pricing in other asset classes. Instead, we expect UK-specific growth risks, which stem from the cost-of-living crisis and potential political conflict with the EU over article 16, to remain the dominant bearish driver for GBPUSD, keeping the currency pair below the 1.30 handle over the coming quarter.

> Over the medium-term, a reduction in global growth risks and a broad weakening in the US dollar should result in GBPUSD climbing back above the 1.30 handle.

CAD

The Canadian dollar weakened substantially over the last week of April, with USDCAD breaking through the 1.28 handle after previously trading near our April 1-month forecast of 1.24. The move was primarily the result of increased cross-asset volatility, which embedded a level of risk premium into USDCAD. Compounding the loonie's depreciation has been the slight deterioration in the currency's fundamentals, such as interest rate differentials and oil prices. However, they have not shifted enough to explain the bulk of the CAD move at the end of April. With the 2Y yield differential turning 4.5bps more favourable for the US over the course of the month, and Canada's benchmark crude oil price falling just 2% since April 21, we expect some degree of mean-reversion in the USDCAD rate as market fears abate and excess risk premium fades in the near-term. This is reflected in our one-month forecast, which now sees USDCAD falling back to the 1.26 handle. Gains beyond there are likely to be limited as previous drivers, like the positive terms-of-trade shock, have already been factored into the USDCAD pair.

Despite adjusting our forecasts to represent developments in April, our medium-term view on interest rate pricing still stands. We continue to believe that market pricing for the path of interest rates is too aggressive for most major central banks outside of the Federal Reserve. Over the last few days, money markets have pared back their expectations of where the Bank of Canada's overnight rate target will sit by the end of 2022; at 2.85% however, that rate is still 35bps higher than what markets expected on April 1. With 3 consecutive 50bp hikes almost fully priced at the BoC's next 3 meetings, we think the money market is positioned for disappointment, and that pricing will ease in the second half of the year after the BoC starts to underdeliver. We expect that to weigh on CAD in the medium-term, although given the imperfect relationship between FX and money markets, it is difficult to gauge the extent to which a dovish repricing will weigh on the loonie. In the early parts of 2023, we expect the pace of BoC tightening to exceed that of the Fed as rates in the US already sit in neutral territory at this point. All things equal, this should see a renewed CAD bid towards the latter part of our forecast horizon.

CNY

The combination of higher US rates and expectations of policy easing in China, due to rising Covid cases inducing lockdowns and thus producing a lower growth profile, weighed on the Chinese yuan in the latter part of April. The case for a weaker yuan was reinforced by the PBoC's fixings, which suggest the central bank has a slight depreciation bias. While we had long argued for a weaker yuan, the readjustment has occurred earlier and been faster than we previously expected, largely due to renewed lockdowns across mainland China. Following a 4% drop over the course of April, we expect the yuan's depreciation to slow in May as officials push back against market forces to control the inflation passthrough and offset concerns that CNY depreciation could result in substantial capital outflows. Given the yuan's relative strength on a trade-weighted basis, we expect USDCNY to continue grinding higher over the medium-term, but the pace of adjustment to be managed slower by the central bank.

"The case for a weaker yuan was reinforced by the PBoC's fixings, which suggest the central bank has a slight depreciation bias."

BRL

The Brazilian real's strength year-to-date has been eroded somewhat over the latter part of April as previous tailwinds began to moderate. On the rates side, higher US interest rates and expectations that the BCB is entering the latter part of its hiking cycle as growth conditions respond to higher domestic interest rates have reduced the real's carry appeal. Additionally, lower global growth expectations have limited the impulse from higher commodity prices, with the positive terms-of-trade shock now largely factored into the real. We expect the USDBRL rate to climb back above 5 in the near-term as election risks start to build, before US rates stabilise and election risks dissipate to prompt a BRL recovery toward the end of H2.

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Currency Pair	1-month (31st May 2022)	3-month (31st July 2022)	6-month (31st Oct 2022)	12-month (30th April 2023)
G10				
EUR/USD	1.035	1.08	1.10	1.14
USD/JPY	133	130	128	125
GBP/USD	1.24	1.28	1.32	1.34
USD/CHF	0.981	0.958	0.955	0.947
USD/CAD	1.26	1.275	1.30	1.26
AUD/USD	0.72	0.73	0.73	0.75
NZD/USD	0.64	0.65	0.67	0.69
USD/SEK	9.86	9.44	9.09	8.77
USD/NOK	9.47	8.89	8.73	8.42
DXY	104.69	101.3	99.66	96.69
Emerging Markets				
USD/CNY	6.7	6.75	6.8	6.8
USD/INR	76.5	76	75	75
USD/ZAR	16	15.6	15	14.8
USD/TRY	14.8	15	15	14.5
USD/RUB	72	72	72	72
USD/PLN	4.54	4.26	4.27	3.90
USD/HUF	357	343	345	316
USD/CZK	23.67	22.96	23.18	22.81
USD/BRL	5.1	5.2	5.4	5.0
USD/MXN	20.5	21	21.5	21
Euro Crosses				
EUR/GBP	0.835	0.844	0.833	0.851
GBP/EUR	1.20	1.19	1.20	1.18
EUR/CHF	1.015	1.035	1.05	1.08
EUR/CAD	1.30	1.38	1.43	1.44
EUR/SEK	10.2	10.2	10	10
EUR/NOK	9.8	9.6	9.6	9.6
EUR/TRY	15.3	16.2	16.5	16.5
EUR/RUB	75	78	79	82
EUR/PLN	4.7	4.6	4.7	4.45
EUR/HUF	370	370	380	360
EUR/CZK	24.5	24.8	25.5	26
EUR/BRL	5.3	5.6	5.9	5.7
EUR/MXN	21.2	22.7	23.7	23.9