Monex October 2022 **FX Forecasts**

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Introduction

Monumental. Historic. Chaotic. These are just a few adjectives that characterise the last month of trading in FX markets. September kicked off with the Federal Reserve's decision in focus, as numerous officials had stressed back in August that they were waiting for data to decide whether 50 or 75bps would be more appropriate. The main two pieces of information that would inform those decisions were the nonfarm payrolls report on September 2nd, and the CPI inflation report on September 13th. Money markets took those communications to heart, with pricing in futures and swaps hovering between 50 and 75bps, albeit leaning slightly in favour of 75bps. The payrolls data showed a strong headline print, with 315,000 jobs added on net, but weaker-than-expected wage growth dampened the signal, making the report insufficient to sway traders either way on their expectations for the decision. While awaiting the US CPI release, traders saw the Bank of Canada and European Central Bank both hike their policy rates by 75bps, showing resolve in their commitment to tackle inflation in their respective economies, while Fed officials dialled up their hawkish rhetoric and led money markets to fully price a 75bp hike without even seeing the inflation numbers. When the 13th finally rolled around, strength in the CPI report, particularly core CPI, was so robust that money markets began to consider 100bps, not 50, as the second-most likely option for the Fed, initiating a swift upward repricing in USD that wiped out three consecutive days of losses. Money markets then settled around a base case of 75bps, with a 1-in-5 chance of 100bps, which we argued at the time was overstretched. Following the US inflation report, volatility died down for about a week as the data calendar thinned out following the delay in the Bank of England decision.

> While US developments took priority for FX markets over the course of the first half of the month, the third week of trading saw a broadening in the drivers of FX volatility: central bank meeting after central bank meeting, along with a handful of CPI and PMI releases, worked in tandem to keep traders on their toes.

Although the week started on a quieter note as UK markets were closed for the Queen's funeral, meaning liquidity conditions in Europe were lighter than usual, markets came roaring back on Tuesday as Sweden's Riksbank was the first central bank up to bat in the three-day flurry of interest rate decisions. Starting the week of monetary tightening, the Riksbank came, guns blazing, and hiked its repo rate by 100bps to 1.75%. That was just the appetiser to the next day's main course from the Fed. Although the 75bps hike met market expectations, it was delivered with a side order of hawkish forward guidance. This was mainly provided via the Fed's dot plot projections, where its forecasted rate for the end of 2023 was raised by 87.5bps to 4.625%, with 125bps signalled for the remaining two meetings this year alone. The dot plot revisions were so unexpectedly hawkish that markets didn't know how to process the information—participants couldn't tell whether the Fed was credible, bluffing, or just overconfident.

The dollar immediately whipsawed in response, but eventually a consensus formed that the Fed was serious. Money markets gradually upped their terminal rate expectations, aligning them with the Fed's projections, while also pricing out previously expected cuts in H2 2023. This coincided with a rally in front-end Treasury yields, with the 2-year breaking 4% for the first time since 2007. This helped to support the next leg of the dollar rally. Rounding off the day was the Central Bank of Brazil, who followed through on a well-signalled pause in its tightening cycle having already delivered 1,175bps of tightening since the start of 2021 to stay ahead of the curve in its fight against inflation.

In normal times, an **ultra-hawkish Federal Reserve** would have been the most memorable event of the month, let alone the week. However, with higher US rates placing further pressure on the Japanese yen overnight after the Bank of Japan confirmed its yield curve control framework, Japan's Ministry of Finance was forced into intervening in markets for the first time since 1998 to offset the slide in the yen.

This started with a warning from officials that stealth intervention may take place, but with the broader market undeterred by the threat, MoF officials made good on their promise by buying close to $20bn worth of Japanese yen, sending the pair 3.5% lower before confirming their involvement. Later that day, the Swiss National Bank raised its policy rate by 75bps, initiating a sell-off in CHF as traders had hoped for a full percentage point increase, while the Bank of England raised rates by 50bps and confirmed its commitment to begin quantitative tightening in October – a decision they would soon come to rue.

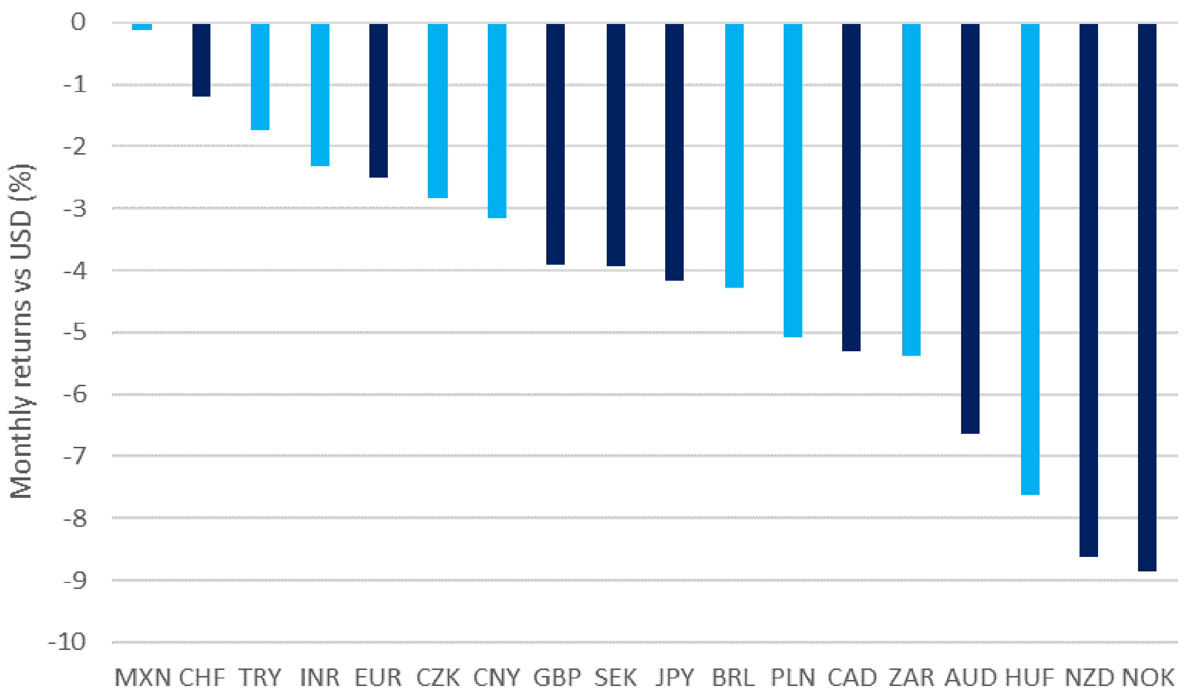
Just prior to the weekend, the focus for markets switched from monetary to fiscal policy as the new British government set out their mini-budget plans in light of their recent energy cap commitment. The decision by the Chancellor to restrict the Office for Budgetary Responsibility from publishing flash projections, to not expand upon any direct revenue generating policies or offsetting spending cuts, and to announce broad income tax cuts that would add to the Bank of England's inflation battle sent UK markets into meltdown. Although the bond market and the pound responded aggressively to the budget measures on Friday, the turmoil persisted in the following week. The pound opened Monday's session substantially lower, although up from an all-time low recorded in overnight hours, with the currency depreciation forcing the Bank of England into announcing that it wouldn't raise rates in an inter-meeting decision after speculation in short-term interest rate markets mounted. From there, the focus shifted to turmoil in gilt markets after the 30-year bond rallied to 5% and raised concerns over liquidity conditions. This forced the BoE to backstop liquidity conditions as margin pressures threatened overall financial stability.

In a market where US rates are north of 4%, cross-asset volatility sits close to pandemic highs, and the macroeconomic backdrop is progressively becoming more stagflationary, the broad dollar hit a fresh 20-year high before it moderated somewhat on month-end/ quarter-end flows.

Although speculation around multi-lateral intervention rose as the dollar reached its cycle high towards the end of September, especially as EM central banks started to push back on the stronger dollar narrative, we think this scenario is unlikely at present levels.

Looking ahead, we see further USD strength over the winter months as the Fed remains committed to tightening policy rates, even at the expense of a recession, and global growth conditions force markets back into USD long positions. We don't currently expect to see the pivot in the broad dollar until next year when we expect US macroeconomic data to start testing the Fed's resolve on its policy of restrictive rates for the entirety of 2023 and global growth conditions start to become more supportive for risk assets.

DM currencies lead losses against the dollar in September as EM central banks start to intervene



Our thoughts on DXY, EUR, CHF, GBP, CAD, Antipodean, NOK/SEK, and Asian interventionists

DXY

Despite declining on month-end/ quarter-end flows towards the end of September, we expect FX traders to re-engage with USD long positions in Q4 as global growth conditions deteriorate further and the Fed follows through on its forward guidance by hiking a minimum 100bps before year-end.

The path is unlikely to be smooth for the broad dollar, however, as volatility conditions are set to remain high, especially with liquidity concerns in global bond markets, and central banks start to push back against the strength of the greenback.

Nonetheless, the underlying structural USD bull case is likely to remain intact. That is, US growth is set to outperform that of European nations and pockets of Asia given an extremely tight labour market, high levels of household savings, and economic insulation from the upcoming energy crisis. In addition to this, risk aversion among global investors is likely to remain elevated given the level of cross-asset volatility and the continued deterioration in global growth conditions, making the risk-free rate in the US of around 4% an attractive haven option.

Although our base case is founded on the Federal Reserve avoiding a US recession in the coming quarters, a sharper downturn in the economy to the point that a recession occurs in the US is unlikely to result in a structural pivot in the DXY index before 2023 either. This is due to our view that a downturn in growth conditions is unlikely to deter the Fed from carrying out its projected hiking cycle in the short-term unless it coincides with a material downturn in core inflation pressures, which we deem unlikely given the current inflation drivers have high historical persistence. Instead, a hard landing narrative is likely to result in Fed rate cuts being re-priced in markets from Q2 onwards, which we don't see weighing too extensively on the dollar in the near-term. However, it does pose a slight downside risk to our DXY forecasts as the moderation in Treasury yields will ease pressure on currencies with cheap valuations.

Over the medium-term, even in the case of a soft landing, we don't expect the Fed to meet its current forward guidance that see's a 2023-end rate of 4.6%. Instead, we viewed the Fed's latest dot plot as a means for the central bank to keep financial conditions tight at a time when the disinflationary channel is starting to form as opposed to a firm commitment to taking rates well into restrictive territory and holding them there. As early as Q1 2023, we think the US economic data will start to challenge the Fed's resolve and lead markets to begin factoring in rate cuts from Q2 onwards. Coupled with improving growth conditions globally from Q2, this macroeconomic backdrop should lead traders to start pricing out some of the dollar length that we have seen accumulate over the course of this year.

EUR & CHF

The combination of a continuation in the Fed's aggressive hiking cycle and a cold winter under our base case points towards a deeper recession in the eurozone than markets are pricing at present. Amid the deteriorating growth backdrop, and pressure from rising US rates, we think the ECB's hiking cycle will prove ineffective in supporting the euro over the winter months, especially as higher rates aren't coupled with a stronger equity performance. Amid this backdrop, and the potential for further instability within the eurozone bond market as growth conditions deteriorate, we continue to see downside in EURCHF in the coming months, although two-sided risks remain.

To the upside, the success of the SNB's monetary policy actions in weighing on inflation poses a risk that their tolerance over a stronger nominal CHF starts to wane. To the downside, risks of a deeper recession from more extensive energy rationing measures and the impact that will have on Italian debt sustainability are prominent.

GBP

Despite the recent rebound in the pound towards the end of September, which we assign to technical factors such as portfolio adjustment due to liquidation efforts and month-end/ quarter-end flows, foreign investor sentiment on GBP assets and the UK's fundamentals remains weak. In this regard, we expect the recent GBP rally to prove transitory and the UK's deteriorating fundamentals—higher core inflation, more restrictive monetary policy, lower growth and a widening of the current account deficit—to come to the fore for FX traders over the course of Q4.

> In our view, this should take the pound back towards the 1.05 region over the coming months as currency markets are forced to clear the pressure on the UK's balance of payments.

Although we welcome the government's U-turn on the cut to the 45% tax rate as a sign of fiscal responsibility, the measures are merely cosmetic and the damage to investor confidence has already been inflicted. Thus, the need for higher risk premium remains. This requires the Bank of England to underpin higher gilt yields with higher short-term interest rates in November. Should the MPC point towards undershooting the market's expectations of a minimum 100bps rate hike, compounding its more conservative stance in tightening rates relative to other G10 central banks year-to-date, we believe our 1-month forecast of 1.05 will be tested to the downside. Risks to our GBPUSD forecast over the coming two quarters are plentiful due to intervention measures taken by the Bank of England, the unstable fiscal and political backdrop, and the open-ended nature of the government's upcoming liabilities.

CAD

With the Bank of Canada front-running the Fed's hiking cycle and the Canadian economy experiencing a positive terms of trade shock, the loonie scanned as the best performing G10 currency against the dollar year-to-date at the end of August (-3.5%) despite its historically high sensitivity to global risk sentiment. However, our outlook for the loonie over the coming 6-months has turned substantially less constructive over the course of September.

Firstly, front-end rate differentials have recently turned positive for USDCAD following a more conservative BoC meeting at the start of the month, where the central bank dropped references to front-loading its hiking cycle and pointed to a period where policy will take a more fine-tuned nature, which contrasted with the more hawkish tone from the Fed. Under our base case scenario, the BoC raises rates by a further 75bps this year due to a cooling in core CPI pressures and a higher sensitivity of the real economy to monetary policy due to Canada's leveraged housing market. Relative to our expectation of a minimum 100bps worth of additional rate hikes from the Fed and a terminal rate in the region of 4.5%, front-end rate differentials should continue to support a higher USDCAD rate. Secondly, tighter US financial conditions are likely to weigh on overall risk sentiment and global growth conditions, hampering the loonie through both the equity and terms of trade channel—although the latter can be partially offset by production cuts in oil markets. Barring a U-turn by the Fed, we see these developments as sufficient in preventing USDCAD from trading back below 1.30 over the medium-term. Risks to our forecasts are balanced over this horizon.

To the upside, risks largely centre around a more aggressive reaction in Canada's housing market to the rapid pace of tightening, while an even more hawkish Fed also poses some risk. To the downside, a cooling in core inflation pressures in the US suggest rate differentials would narrow ahead of our expectation for the Fed to pause or even reverse its hiking cycle from Q2 2023.

Antipodean

After plumbing fresh pandemic lows in September, we expect the Aussie and Kiwi dollars to rebound in Q4 despite the tentative global growth backdrop. This is largely based on our expectation that further fiscal stimulus will be announced in China over the coming month following the National Congress and measures by the People's Bank of China to stabilise the slide in the yuan will prove effective and backstop the spill over into Antipodean FX. In the near-term, risks are tilted to the downside and largely centre on a slowdown in the RBA's and RBNZ's respective hiking cycles and continued sensitivity to global growth conditions despite already cheap valuations.

NOK & SEK

Although the Norwegian economy continues to experience a positive terms-of-trade shock, its impact is no longer felt by the Norwegian krone as the central bank continues to buy foreign currencies at a record pace to deposit energy revenues into the nation's sovereign wealth fund. This leaves EURNOK highly exposed to regional risk sentiment and support for the currency is dependent on tighter domestic financial conditions. Under our expectation of a deterioration in Europe's economic fundamentals over the winter months, we expect regional risk conditions to sour and place further pressure on the krone that will only be partly offset by the continuation in the Norges Bank's hiking cycle to a peak rate of 3%.

Similarly, we expect the Swedish krona to come under continued pressure in this macroeconomic environment as the Riksbank's decision to hike rates by 100bps in September provided only temporary support for SEK given its impact on lowering the projected terminal rate. We expect the Riksbank to hike a further 75bps in November, in line with market expectations, before holding rates at that level amid financial stability concerns.

Asian Interventionists (CNY, INR, JPY)

In the environment of a stronger dollar and higher US interest rates, central banks in Asia have started to intervene either directly or indirectly in FX markets. Japanese authorities have been the most aggressive in this regard, with the BoJ purchasing nearly $20bn in the FX market directly in September to offset pressure on the yen around the 145 region. However, despite the BoJ's efforts on behalf of the Ministry of Finance to re-introduce two-way risk in the currency pair, we believe their efforts will only slow the pace of JPY depreciation in the coming months as opposed to reversing it. With the BoJ showing no signs of abandoning its ultra-loose monetary policy stance and widening rate differentials set to keep pressure on the yen, we see USDJPY grinding higher in the near-term, albeit at a reduced rate due to unilateral intervention efforts. Over the medium term, we expect the BoJ to exit its ultra-loose policy stance, prompting a substantial capital inflow and a strong rally in the yen. In the near-term, rising recession risks and the pressure that will have on US rates poses a downside risk to our USDJPY forecasts, with the yen potentially regaining its status as a haven currency. Conversely, upside in US rates may have the same effect as it could bring forward the Bank of Japan's plans to normalise policy should its reserves start to deplete at a rapid pace.

Contrary to direct intervention in Japan, officials in China and India have taken a more nuanced approach by tightening capital controls and looping in the assistance of state actors.

The decision by Chinese authorities to instruct state banks to build up USD reserves to stave off a slide in CNH, increase reserve requirements for FX options, and to reintroduce the countercyclical factor in the daily fixing is to slow the depreciation in the yuan and protect against any dramatic depreciation during the domestic market closure for Golden Week at the start of October. Given the yuan's depreciation is much more limited on a trade weighted basis, we don't believe officials are going to up the ante on intervention methods in the near-term, although this may occur if markets attempt to sell USDNCY beyond the politically sensitive 7.2 level ahead of the National Congress. Over the medium-term, stability in the USDCNY rate differential due to the end of the Fed's tightening cycle and reduced concerns over China's growth profile as a result of more active fiscal policy should see the yuan rally with improved global growth conditions.

After the rupee traded in a 2% range for the entirety of July and August, during which time the broad dollar rallied 4%, the depletion of India's external reserves and increased USD pressures led authorities to drop intervention efforts in September. This resulted in a 2.4% jump in the currency pair over the course of the month. Continued rate pressures from the US and higher oil prices lead us to believe that further INR depreciation is in store over the coming months, but we note that officials' preference for state refiners to finance their USD liabilities via domestic swap lines as opposed to using international spot/forward markets could be a sign that further intervention is forthcoming in what will then be a softer market. Therefore, we anticipate a limited depreciation in the rupee to 83 over the coming quarter.

FX Forecasts

October 2022

MONEX

Forecasts

Currency Pair	1-month 31st Oct 2022)	3-month (31st Dec 2022)	6-month (31st Mar 2023)	12-month (30th Sep 2023)
		G10		
EUR/USD	0.96	0.95	1.00	1.07
USD/JPY	147	145	135	125
GBP/USD	1.05	1.07	1.12	1.18
USD/CHF	1.00	1.00	0.98	0.935
USD/CAD	1.38	1.40	1.37	1.30
AUD/USD	0.66	0.67	0.67	0.71
NZD/USD	0.57	0.58	0.59	0.62
USD/SEK	11.46	11.58	10.50	9.53
USD/NOK	11.35	11.58	9.80	8.88
DXY	114.78	115.20	109.42	102.41
		Emerging Markets		
USD/CNY	7.2	7.1	6.9	6.8
USD/INR	83	83	80	75
USD/ZAR	18.5	18.5	17.5	17
USD/TRY	19	19	19.25	18
USD/PLN	5.10	5.26	4.70	4.11
USD/HUF	448	458	410	364
USD/CZK	25.5	26.1	24.5	22.4
USD/BRL	5.3	5.0	4.8	5.0
USD/MXN	20.0	19.8	19.5	19.0
		Euro Crosses		
EUR/GBP	0.91	0.89	0.89	0.91
GBP/EUR	1.09	1.13	1.12	1.10
EUR/CHF	0.96	0.95	0.98	1.00
EUR/CAD	1.325	1.33	1.37	1.39
EUR/SEK	11.0	11.0	10.5	10.2
EUR/NOK	10.9	11.0	9.8	9.5
EUR/TRY	18.24	18.05	19.25	19.26
EUR/PLN	4.9	5.0	4.7	4.4
EUR/HUF	430	435	410	390
EUR/CZK	24.5	24.8	24.5	24.0
EUR/BRL	5.09	4.75	4.80	5.35
EUR/MXN	19.2	18.8	19.5	20.3