FX Forecasts

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INTRODUCTION

Monetary policy continues to be a dominant driver of FX markets at the start of 2023, but unlike the past year, it is no longer the only catalyst. Markets are now becoming more sensitive to relative growth differentials, especially as US recession fears remain front and centre for investors after a year of historic monetary tightening. While market concerns persist over the state of the US economy, developments outside of the US have largely been supportive of global growth as Europe looks to have evaded the worst of the energy market crunch following a tepid winter and lower Chinese demand for LNG, while China's earlier and sustained reopening has also resulted in consensus growth forecasts being revised up–we now see an earlier peak in Chinese growth this year in Q2 2023. In asset markets, this has resulted in regional rotation out of the US towards exposure to improving eurozone and Chinese growth.

Growth conditions haven't just had implications for capital flows and FX performance, but they are also starting to impact pricing of monetary policy. Slowing growth has led North American central banks to take a more conservative approach to monetary policy tightening in order to observe the lagged effects of previous hikes and to prevent a policy-induced recession. Notably, this has seen the market implied path for the Fed funds rate flatten over the past month. Terminal rate pricing has fallen modestly to 4.9%, while the number of rate cuts priced in for the second half of the year has fallen to around 40bp as per the eurodollar futures curve. Concerns over growth and the lagged impulses from last year's tightening cycle have not only weighed on the Fed's path for interest rate this year, but have culminated in the Bank of Canada going one step further as they officially announced a likely end to their hiking cycle at a terminal rate of 4.5%. Expectations are that the Fed isn't far behind as inflation conditions cool with aggregate demand and labour market data shows preliminary signs of a rebalancing. This stands in stark comparison with the ECB, who have spent the past fortnight stamping out speculation that lower energy inflation would prompt an earlier slowdown in their hiking cycle. ECB officials instead switched their focus from headline inflation and the impact it would have on inflation expectations to the trajectory of core inflation, especially under an improved outlook for aggregate demand and an historically tight labour market. In doing so, Governing Council members retained their hawkish guidance from December's meeting, with President Lagarde stating that the central bank would "stay the course".

The combination of lower US yields due to a dovish repricing of the Fed funds rate in markets and improving growth conditions outside of North America has been supportive of risk sentiment and has consequently weighed on the dollar over the past month.

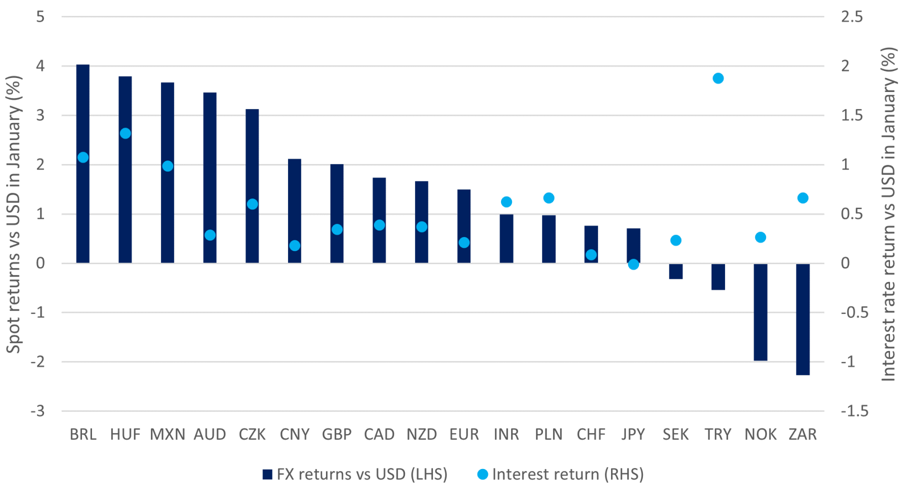
> "Despite a further decline in the broad DXY index in January, the dollar's decline has been neither smooth nor visible across all major currencies."

In the expanded majors space, currencies with high exposure to improving growth conditions in the eurozone and China have notably rallied, while those that also exhibit high real rates have broadly led gains. However, exposure to improved regional growth conditions hasn't universally benefitted all currencies. NOK and SEK, for example, have failed to take advantage of improving growth conditions in mainland Europe despite their high beta to eurozone growth conditions. Meanwhile, the South African rand, which scans as a relatively high yielder with exposure to increased Chinese commodity demand, fell 2.26% against the dollar over the course of the last month.

Differentiation against the dollar can partly be explained by idiosyncratic factors

For example, narrowing rate differentials due to a more hawkish ECB and housing market concerns have weighed on both NOK and SEK, while the Norwegian krone's underperformance has also been turbocharged by the Norges Bank's FX sterilisation measures. Meanwhile, in both Brazil and South Africa, a turbulent political backdrop and risks to growth conditions have hampered overall performance.

Currencies with positive carry and exposure to improved regional growth outlooks led gains against the dollar, but that wasn't sufficient for universal appreciation



Beyond Fed developments and improved growth conditions in some of the largest global economies outside of the US, January will be remembered as the month where markets tested the Bank of Japan's resolve when it comes to yield curve control. Speculation that the BoJ might loosen the reins further or even abandon the policy altogether coincided with mounting concerns over a US recession to push USDJPY to lows of 127. However, on the 18th of January, the BoJ stuck by its guns as it held all of its policy measures as it awaits the results of the Spring wage negotiations. As recession concerns and pressure on the 10-year yield target abated, the Japanese yen retraced to our one-month target of 130.

By and large, price action at the start of the year has exhibited the traits we highlighted in our 2023 outlook. That is, still-elevated volatility, short-term trends, and divergence in returns against the dollar, all of which were generated by conflicting inflation and growth signals. Admittedly, the improvement in growth conditions outside of the US has occurred earlier than we expected and led to a few of our medium-term forecasts being realised over the past month. Accounting for the improved regional outlooks, we have revised up our structural forecasts for some pro-cyclical currencies that look set to maintain positive carry after marking them to the market. However, we remain hesitant about further USD depreciation in the coming months despite our lower-than-consensus view on the Fed's terminal rate due to still tentative US growth conditions, crowded positioning in popular expressions of growth rotations, elevated expectations for China's economy to live up to, and prominent financial stability risks. We continue to believe H2 2023 will provide clearer air for a secular decline in the dollar.

FX VIEWS

DXY

Down but not out

The broad dollar has depreciated close to 2% over the past month, primarily due to growth rotation into Europe and Asia and improved risk sentiment on signs of sustained disinflation in the US. Despite the continuation in the dollar's decline from September's highs over the past month, we think the dollar is likely to consolidate above the 100 threshold on the DXY index in the near-term. Underpinning our view of short-term USD resilience is our judgement that the cyclical optimism baked into markets is starting to look stretched–especially given our more bearish views on China's immediate economic reopening, and concerns that a US recession hasn't been completely avoided, despite signs that it is unlikely in Q1– and our expectation that market pricing of the Fed is ultimately going to re-align with the central bank's preference for duration in restrictive policy. This implies a steepening in the swaps curve for H2 2023. Whilst there are risks to this forecast, for example a failure to raise the debt ceiling, the Fed significantly over tightening or a very sharp rise in unemployment, we see the likelihoods for these scenarios falling significantly outside our base case and the consequences difficult to quantify. Further out in our forecast projection, as global growth conditions start to improve in H2 2023, with the drags from tighter monetary policy starting to fade and cooling inflation bringing forward rate cut expectations for major DM central banks, we believe the stage is set for cleaner USD depreciation.

EUR

Hurdles remain before the 1.10s become sustainable

Back in December, we anticipated that improving energy conditions and soft survey data would likely support EURUSD in the early months of 2023, but we remained cautious on the single currency's fortunes given the potential turnaround in the energy outlook due to cold weather warnings. However, despite brief cold snaps over the past month, levels of gas in storage remains historically high while European energy prices have fallen to pre-war levels. Owing to this, the eurozone growth outlook has improved significantly as the prospect of competing to refill inventories at a time when China's energy demand would reach pre-pandemic levels has largely been evaded this year. This has resulted in EURUSD rallying to levels we didn't expect to be reached until global growth conditions improved in H2 2023. In light of the improved energy outlook, and the correspondingly hawkish stance taken by the ECB, we have upwardly revised our EURUSD forecasts across the entire forecast horizon. However, despite this increasingly optimistic view on the single currency, we think it will trade fairly range bound in the coming months as portfolio inflows from the real money community remain absent, threats to the overall risk environment will likely support USD demand, and the bulk of the growth improvement and narrowing in rate spreads has already been priced in. Previously, the ceiling on EURUSD at the 1.10 threshold wasn't expected to in scope until Q4 2023, but given the expedited timeline for the euro rally, we expect it to start binding in upcoming weeks as the level of resistance to further appreciation increases. Over the longer-term, we expect structural limitations to persist due to energy dependence and the vulnerability of peripheral bonds.

CNY

Re-opening momentum starts to fade

The appreciation in CNY at the start of the year has been far more aggressive than we had anticipated, largely due to increased local corporate CNY demand ahead of the Lunar New Year. However, with China's economic reopening now largely factored in across a number of asset classes and the PBoC's tolerance of CNY strength turning more neutral, we expect USDCNY to remain fairly range bound over the next three-months. Turning towards the middle quarters of the year, expectations of rate cuts from developed market central banks at a time when China's economy is likely to experience higher levels of consumer inflation will likely see rate differentials in USDCNY narrow.

> "Coupled with an expected recovery in growth conditions, we expect this dynamic to generate another leg lower in the currency pair."

Risks over this time frame are largely tilted to the upside. The primary risk is China's economy underperforming market expectations, which we believe is more elevated than the current level of cyclical optimism is suggesting given China's lacklustre transition to a domestic consumption driven growth model pre-pandemic. Another right tail risk to our medium-term forecast is rising geopolitical risk. An improvement in Chinese growth conditions may pivot Beijing's focus towards extending its regional influence. Signs of an imminent invasion of Taiwan will prompt a sharp outflow of foreign capital given the sanctions playbook that has already been presented by the US towards Russia.

LATAM

Positive carry warrants an extension in the rally

The Mexican peso has been steadily appreciating since the start of Q3 2022, but over the past month, the pace of appreciation has accelerated. Behind this MXN rally are a diverse set of drivers, which include: Mexico's relatively stable macro fundamentals relative to regional peers, the faster-than-expected reopening of the Chinese economy and the impact that has had on the risk environment, and even more importantly, the peso's attractive carry traits due to a resilient hiking cycle from Banxico and Mexico's relative political stability. The question for markets to now mull over is how long this trend of MXN appreciation can last. In terms of positive carry, recent core inflation data suggests that Banxico won't be given the freedom to cut rates anytime soon, while it also poses risks of an extension in their hiking cycle beyond our expectations of a Fed pause. A synchronised pause with the Federal Reserve won't necessarily weigh on MXN's appeal, however, as it will likely support the return of foreign investors to Mexico's bond market, a dynamic that is likely to spillover into currency markets. While we are hesitant that long MXN has become a popular trade amongst sell-side analysts and that MXN has come a long way quite quickly, we think supportive fundamentals are likely to keep the peso around recent levels as spot MXN remains fairly aligned with an array of fundamental models. Risks to our near-term USDMXN view are fairly balanced. To the downside, improving conditions for risk and a more dovish Fed stance are likely to fuel a continuation in the popular carry expression, while a more pronounced slowdown in US and/or Chinese growth pose the largest upside risks.

"Appreciation in BRL over the past month hasn't been as plane sailing as MXN, largely due to the level of political turbulence."

However, with discourse from the Lula government now suggesting the path for fiscal policy will be much more restrained than initially suggested, we believe the path for further BRL appreciation is clearer. With the BCB resolute in its battle to lower inflation, holding interest rates at 13.75% despite inflation falling from a peak of 12% to 5.8% as of January, the real's positive carry is likely to drive investor appetite for BRL exposure. Additionally, China's reopening also remains supportive for both Brazil's external accounts and overall risk conditions, the latter further supporting carry trades into the real. While BRL is becoming somewhat more expensive relative to where fundamentals place it, we think the rally could have further to run in the near-term. Risks to the front-end of our USDBRL forecast are largely to the upside and pertain to the risk environment. Recession fears in the US, underwhelming growth data out of China, and further political volatility domestically all pose upside risks to our 3-month USDBRL forecast.

ZAR

Hampered by domestic factors

External market conditions have turned more constructive for the rand over the course of January. China's reopening has provided a positive growth impulse for the South African economy, while overall market conditions are now more conducive for EM carry trades. Despite this, the South African rand underperformed all currencies within the expanded majors in January as investor sentiment remains heavily depressed by domestic growth risks. Most of the ZAR underperformance can be attributed to acute energy shortages, with Eskom now embarking on level 6 loadshedding. With very little relief for the energy outlook on the horizon, growth in South Africa is set to remain incredibly restricted. In January, the South African Reserve Bank estimated that rolling blackouts are set to wipe as much as 2% off economic growth this year as they lowered their 2023 GDP outlook from 1.1% to just 0.3%. Owing to the lower growth outlook, the SARB opted to drop the pace of its hiking cycle from 75bp increments to just 25bps, undershooting market expectations in doing so. It isn't just the softer growth outlook that is weighing on the rand's nominal carry potential. At January's ANC conference, the government discussed the idea of altering the SARB's mandate for them to actively target stronger growth and employment, which also argues for lower interest rates moving forward. Beyond concerns around loadshedding, Transnet's ability to meet demand for its rail and port transport services is also weighing on potential export-growth and potential greylisting by FATF also puts the investment profile of South Africa into question. Overall, we think that the outlook remains bleak in the near-term and expect USDZAR to remain in current ranges. This, in effect, would result in ZAR depreciation on a trade weighted basis as per our forecasts.

CE3

Taking different paths

On the eastern fringe of the EU and uncomfortably close to a newly belligerent Russia, the geographical situation of the CE3 economics was unenviable in 2022. All three suffered from a large spike in energy prices and inflation, resulting in central banks raising interest rates substantially. The question for 2023 has increasingly focused on when this process will reverse. So far each country has managed to answer differently, with NBP hinting at rate cuts this year, the CNB suggesting it will maintain its policy stance and the NBH actually tightening conditions by raising their reserve ratio and introducing an FX stabilising emergency one-day rate. Given improving growth conditions in the eurozone and overall more supportive risk conditions in markets, divergence among CE3 currencies in January can largely be attributed to their varying levels of carry. As a result, we have seen continued appreciation in both HUF and CZK, but PLN underperformance. The aggressive rallies in both HUF and CZK raise the prospect of a sharp especially in EURHUF where positioning is heavily overweight, fundamentals remain the weakest of all CE3 economies, and political frictions with the EU have re-emerged.

> “For this reason, we have become net bearish on CE3 FX in the near-term after marking our December forecasts to current spot levels.”

Over a longer forecast horizon, we expect an improvement in the energy outlook and real rates environment across the CE3 region to stimulate some appreciation pressure versus the euro, especially in the event that the ECB begins to ease policy. Out of the three regional currencies, we expect PLN to outperform in the medium-term due to its better positioned economic fundamentals and lower base level, with EURCZK trading sideways and a modest rise in EURHUF. Risks to our forecasts are largely tilted towards further CE3 appreciation against the euro in the near-term, owing to the momentum in short EURCE3 carry trade. Over a longer-term, the primary risk to our more constructive CE3 view is the ECB's quantitative tightening plans, which could squeeze EUR liquidity and hamper European satellites.

Scandis

Still chilly up there, but signs of warming up

Given their high beta to growth conditions both in Europe and globally, the Swedish Krona and the Norwegian Krone struggled against the euro in 2022 following the Russian invasion of Ukraine. The rise in energy prices and inflation led both the Riksbank and Norges Bank to raise interest rates, in keeping with peer central banks. However, entering 2023 both banks have indicated that they are close to their terminal rates, with housing market stability a significant concern. This is particularly true of Sweden where a projected terminal rate of just 3% coincides with low growth and over 12% inflation. Norway, whilst facing similar headwinds, has found much of the growth drag from higher interest rates offset by higher energy prices boosting export values. However, this hasn't resulted in a stronger krone as most of the effect of stronger NOK purchases by petroleum companies has been netted off by the Norges Bank's FX sterilisation programme.

While projected revenues have fallen alongside lower energy prices, this hasn't yet filtered through to the Norges Bank's sterilisation efforts, which they recently increased to NOK1.9b per day in February. Although a weaker outlook for energy commodities warrants a slower pace of NOK sales, we don't expect this to occur until midway through the year. This suggests EURNOK should remain near recent historical highs in the coming months. Underperformance of Scandi FX isn't just isolated to NOK in the near-term, especially as rate differentials turn more EUR positive on a hawkish ECB – a key driver of EURSEK upside recently. An ECB pause and an improvement in Scandi growth conditions is likely to take place heading into the second half of the year, providing a welcome boost to the Scandinavian currencies. Although we see medium fundamentals as positive for both currencies, we are materially more bullish over the forecast period regarding the krone given the windfall effects of higher energy exports that we expect to see continue. Risks to the forecast come primarily in a reduction in global growth, particularly regarding conditions in the US and Europe, which would weigh on the value of both currencies. Additionally, whilst not our base case, there is a material risk of a housing market collapse in one or both countries. Whilst unlikely, we see this eventuality as being strongly negative for both currencies given spillover effects.

Forecasts

Currency Pair	1-month (28th Feb 2023)	3-month (30th Apr 2023)	6-month (31st July 2023)	12-month (31st Jan 2024)
G10				
EUR/USD	1.09	1.10	1.12	1.14
USD/JPY	130	125	120	115
GBP/USD	1.22	1.22	1.23	1.28
USD/CHF	0.92	0.91	0.93	0.92
USD/CAD	1.35	1.36	1.32	1.28
AUD/USD	0.70	0.73	0.74	0.78
NZD/USD	0.64	0.65	0.66	0.68
USD/SEK	10.55	10.36	10.00	9.65
USD/NOK	10.28	9.75	9.38	9.12
DXY	102.17	101.05	99.01	96.58
Emerging Markets				
USD/CNY	6.75	6.75	6.7	6.5
USD/INR	83	81	81	80
USD/ZAR	18.0	18.0	17.0	16.5
USD/TRY	18.8	18.9	19.0	19.0
USD/PLN	4.31	4.23	4.11	3.95
USD/HUF	367	364	366	360
USD/CZK	21.8	21.7	21.4	21.1
USD/BRL	5.0	5.0	5.2	5.4
USD/MXN	18.5	18.0	19.5	20
Euro Crosses				
EUR/GBP	0.89	0.90	0.91	0.89
GBP/EUR	1.12	1.11	1.10	1.12
EUR/CHF	1.00	1.00	1.04	1.05
EUR/CAD	1.47	1.50	1.48	1.46
EUR/SEK	11.5	11.4	11.2	11.0
EUR/NOK	11.2	10.7	10.5	10.4
EUR/TRY	20.49	20.79	21.28	21.66
EUR/PLN	4.7	4.65	4.6	4.5
EUR/HUF	400	400	410	410
EUR/CZK	23.8	23.9	24	24
EUR/BRL	5.45	5.5	5.82	6.16
EUR/MXN	20.17	19.80	21.84	22.80

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