MONEX

FX Forecasts

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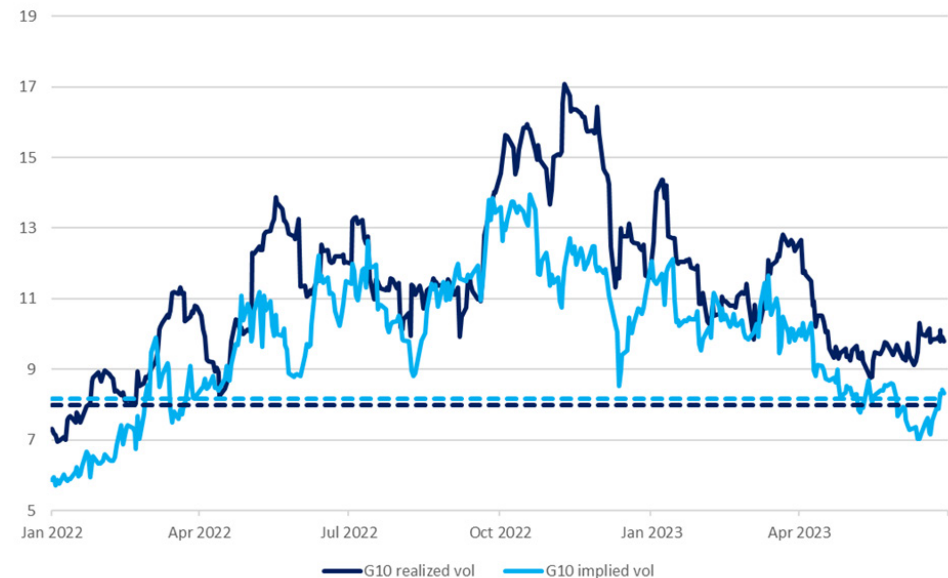
INTRODUCTION

Our 2023 outlook outlined our expectations that this year was set to be a difficult one for investors as the macro environment was set to remain challenging in the form of elevated inflation and rising rates, but would now also incorporate financial stability risks, restricted fiscal space, and growing political fragmentation. All told, we expected this to result in shorter-duration currency trends and still above-average levels of volatility. We also anticipated that the final phases of the Fed's hiking cycle would ease some of the pressure on high beta and low yielding currencies and would result in the broad dollar trading lower. In the first half of the year, this largely transpired.

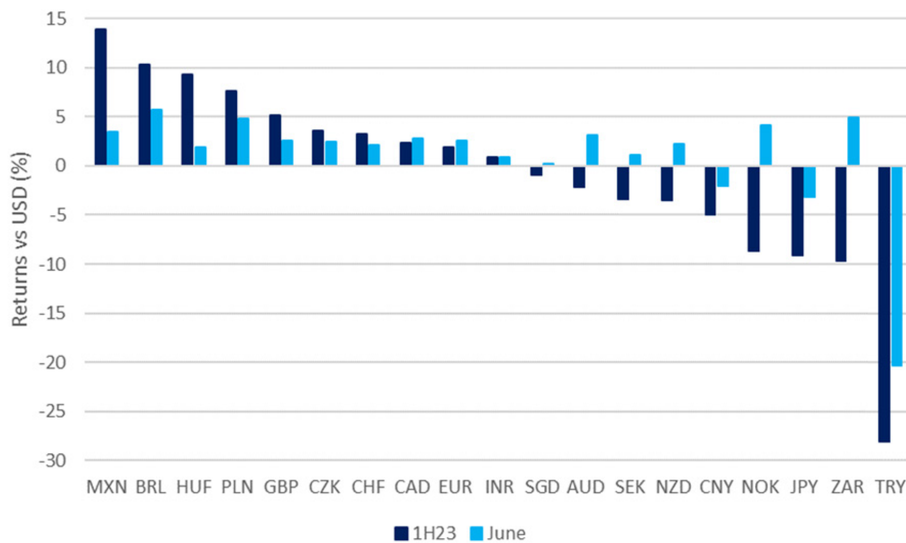
Core inflation pressures stemming from the labour market led terminal rate expectations to rise in the first quarter, notably for the Federal Reserve, before the higher rate backdrop ushered in financial stability risks in the form of a US regional banking crisis and the forced sale of Credit Suisse to Swiss banking rival UBS. Thereafter, the discourse was largely dominated by whether central banks could still engineer a soft landing for the economy, or whether a hard or no landing outcome was more likely. In Q2, as the dust settled on the financial stability risks in March, the general message from central bankers was "higher for longer" as the limitations of more aggressive policy tightening from financial stability risks became a binding constraint. With the duration in which monetary policy remains restrictive now the preference for central bankers as opposed to the terminal level or the pace of tightening, and with the Federal Reserve seen pausing or even ending its hiking cycle as inflation conditions softened, cross-asset volatility finally began to grind lower, driven primarily by lower volatility in the rates space. Although, it must be noted that the levels of realised volatility remained above pre-pandemic averages. At this point, the more benign market backdrop led traders to flock back into high-quality carry trades. The delineation of quality was crucial, however, as rising rates in Q2 didn't necessarily yield positive returns for some currencies as recession concerns and financial stability risks crept back into focus for some economies. For those within the G10, this took the form of commercial real estate and the domestic housing markets, while in the EM space, the concerns were more centred on growth conditions, with China's consumer struggling to live up to expectations and South Africa's productive capacity once again being hamstrung by ongoing energy concerns.

G10 realised and implied volatility ground lower over the course of 1H23, but generally remained above 2016-2019 averages



Zeroing in on the past month specifically, the same themes present for much of Q2 were the prominent drivers of FX yet again. That is, monetary policy differentials and falling realised cross-asset volatility. This saw carry currencies with strong or improving fundamentals outperform once again, especially as front-end Treasury yields struggled to return to their Q1 peaks and rates volatility rolled over as central bank policy decisions now required more compelling evidence from a wider range of indicators. The greater burden of proof to take rates higher was exemplified by the Fed's June decision, which saw them hold rates at 5-5.25% as the latest round of data exhibited conflicting signals. As markets positioned for this outcome, which was then confirmed by the US central bank, the broad dollar found itself trading on the back foot.

Carry currencies with strong or improving fundamentals once again outperformed in June, tying off a strong first half performance



In FX markets, one of the main themes over the past month has not just been the mild depreciation in the broad dollar and the grind lower in realised volatility but also in front-dated implied volatility. Options pricing for many major currencies now foresees something of a traditional summer in FX markets, that is if you believe implied volatility is in fact the best measure of future realised volatility. The other main story over the past month outside of monetary policy has been the divergence in how economic data is printing relative to economist expectations.

> "In China, the latest round of data once again undershot market expectations and in fact proved so concerning that it induced another round of monetary easing from the PBoC."

Meanwhile, in Europe, services activity began to soften, posing a risk to the ECB's hawkish rhetoric, but not enough to change the markets view of a July rate hike as core inflation once again ticked up. This contrasts heavily with data out of the US, which has consistently shown signs that the US economy remains in better shape than markets had necessarily anticipated. Towards the end of the month, the positive surprises in US data saw markets become more sympathetic to the Fed's messaging of two further rate hikes this cycle, leading the dollar to rally off its lows and contain the extent to which it depreciated over the course of the month.

Although the global tightening cycle is approaching its final phase, monetary policy remains one of the primary drivers of market price action. As such, in this month's forecast document, we take a look at what took place in the latest round of central bank meetings and how it informs our outlook for future policy decisions.

Fed: Patiently observing

While Fed members still sounded hawkish for the most part after the May decision, several officials began to change their tune in the lead-up to the June meeting. The incoming data were sending clashing signals, especially in the labour market. Jobs were being either added or shed in May, depending on whether one looked at the establishment or household surveys. Average hourly earnings and unit labour costs told vastly different stories about the pace of wage growth, until a large downward revision to the latter, and alternative data merely added to the noise. Perhaps driven by the desire to see whether an extra month of data would clear up the confusion, some officials began to suggest the Fed could either skip the June meeting or pause for a more extended period of time, although several continued to advocate for further hikes. Despite the cacophony of contradictory messages emanating from the central bank, markets bought into the "skip" view, which was bolstered by a softer inflation reading for May. Before the "skip" narrative took hold, money markets had priced up to a 70% chance of a June hike; by the day before the decision, it was less than 10%. On June 14th, the Fed ultimately eschewed a hike, maintaining the Federal Funds rate between 5% and 5.25%. But the problem that had plagued them earlier in the cycle was back: how to slow the pace of hikes without causing markets to immediately loosen financial conditions for the real economy? Their solution was to revise up their dot plot projections significantly enough that it issued a more hawkish signal. The median dot for 2023 was raised by 50bps, more than virtually anyone had expected. However, the success of this solution was limited as markets didn't initially buy into the Fed's latest guidance. This was mainly because if the Fed deemed that another 50bps worth of hikes was required, why wouldn't they simply hike once more in July before moving to a more cautious stance. Past communication errors had already weakened the Fed's credibility, and markets saw right through the attempt to massage expectations.

"Despite the Fed's best efforts, the market-implied terminal rate hardly budged on the new projections, with OIS markets continuing to price just one more hike for the year."

Following the decision, the Fed stepped away from the limelight while other central banks took centre stage. Numerous hikes, including upside surprises from the Bank of Canada and Reserve Bank of Australia, were accompanied by a chorus of hawkish voices across advanced economy central banks. While this didn't immediately transmit to markets pricing in a greater chance of a second rate hike from the Fed, the hawkish rates backdrop definitely did play a role once strong housing market and consumption data once again raised concerns over inflation persistence. At the end of the quarter, the market implied odds of a second rate hike in Q4 sat at 50%. Under our base case which foresees the US economy entering a mild recession towards the end of the year, we think the Fed will find itself hamstrung on a second hike in Q4 by the improvement in inflation data and the cooling in growth conditions. While risks are very much tilted to the upside, our terminal rate forecast for the US is 5.375%, implying just one further hike in Q3.

ECB: Lagging the Fed

By nearly all accounts, the ECB finds itself experiencing the same lessons as the Fed, but with a lag of one-to-two quarters. Firstly, inflation took longer to arrive in the eurozone. It wasn't until Russia's invasion of Ukraine that inflation began to rise to levels that prompted a policy response from the ECB in July, and for rates to rise above the zero lower bound in September. Comparatively, owing to looser fiscal policy over the pandemic months, the trajectory of inflation prompted the Fed to effectively begin withdrawing monetary stimulus as early as March. Similar to the arrival of inflation, the inflection point in the headline rates were also separated by a lag. Headline inflation in the US peaked at 9.1% in June 2022, with the eurozone measure not peaking until October at 10.6%. The same can also be said about core inflation, which didn't turn in the eurozone until March, six months after the US.

With the trend in eurozone inflation following the US with a lag, it is by no surprise that the rhetoric from the ECB has mimicked the Fed's of previous months. Only recently have markets heard the ECB pivot from talking about disinflation in the headline measure to core, then to core services inflation, and then again to inflation persistence stemming from the labour market. At the June meeting, when providing guidance over a further hike in July, President Lagarde stressed how elevated unit labour costs were. For observant spectators, this type of language was last used to support the Fed's April hike, before the same measure for Q1 was subsequently revised lower. Now, the Fed's emphasis has already moved onto the transmission of previous actions, stressing a "slower pace" of tightening in order to do so having "skipped" a hike at its July meeting. Based on the lags in both economic variables and central bank communications, we don't expect to hear a similar message from the ECB until September's meeting at the earliest.

We expect caution to prevail at September's meeting for two reasons. Firstly, inflation conditions are likely to cool as the effects of previous policy actions filter through to the real economy, similar to that of the US currently. Secondly, and unique to the ECB, we expect internal politics to become a binding constraint. Up until now though, the importance of cooling inflation has received unanimous backing from ECB members. But despite the united front so far, cracks are just beginning to emerge in the facade of European consensus. Comments from Italian Deputy Prime Minister Matteo Salvini at the end of the month, suggesting that the idea of additional rate hikes are 'Nonsense and Dangerous', were followed up by additional criticism from

Prime Minister Giorgia Meloni. Notably this has not translated into open criticism by central bank chiefs, although one of the first hints in this direction came from head of the French central bank, François Villeroy de Galhau. Saying that any further rate rises would be 'limited' and that 'what matters is how long we remain at the terminal rate rather than its level', his comments were widely interpreted as pushing back on the idea of hiking beyond the July meeting. This also follows ECB "sources" stories suggesting that the doves within the Governing Council are gearing up for a September showdown. With markets currently foreseeing one or two more hikes, September looks likely to be both a live and a lively meeting.

China: Growing pains

While most major central banks remained fixated on bringing down inflation in June, the People's Bank of China cut its main policy tools by 10bps following soft inflation and activity data for May. The data, which not only highlighted the uneven composition of growth in the Chinese economy, compounded the signal from April's readings that the Chinese economy is slowing considerably from its strong Q1 reopening. Further underscoring the need for additional stimulus were growing deflation risks as CPI inflation printed at a meagre 0.2% MoM, PPI fell further to -4.6% YoY, and youth unemployment hit a new record of 20.8%. With the growth divergence trade very much in the rear-view mirror for markets and rate differentials widening further, the PBoC's decision to ease policy was looked down upon by FX traders, especially after earlier rumours of fiscal stimulus proved unsubstantiated. The yuan depreciated by almost two percent over the course of the month, prompting the central bank to push back on market forces via stronger fixings and instructing state banks to sell dollars. Looking ahead, while we can't discount further monetary easing from the PBoC, the emphasis is now very much on fiscal policy and whether authorities will support growth conditions in the traditional manner.

Resumers: Proving resilient and persistent

The Bank of Canada and Reserve Bank of Australia surprised markets in June, hiking by 25bps against expectations for no change. For the BoC, this marked the end of a two-meeting long pause after the central bank teed up a pause in January, when it explicitly signalled that it had no plans to raise rates at the next meeting so long as the data evolved roughly as expected. It followed through on that promise in March and maintained the pause at 4.5% in April, but as officials had warned each time that rates could go higher in the future, markets were lulled to sleep by the lack of action. The BoC's April meeting minutes, however, revealed something else. Officials had already begun to grow uncomfortable with upside surprises to inflation, housing, and economic growth, and the minutes made evident that a heated debate had occurred within the Governing Council. While the doves won the debate that time around, uniformly strong data following the April decision made clear that a resumption in tightening loomed ahead. The BoC ultimately hiked by 25bps, meeting our off-consensus call, and given the absence of a resounding improvement in the data since, we believe the hike is unlikely to be a one-off. As such, we now look for a terminal rate of 5%, with the final 25bp hike to be delivered at the July meeting.

The RBA's situation was similar in many respects. In March, the central bank hiked by 25bps but toned down the hawkish guidance, suggesting that future hikes would still arrive but were less imminent than before. A month later the RBA maintained their view of the economy but softened the guidance and held the cash rate at 3.6%. The rationale was, at its core, the same as the BoC's. Officials knew that lagged effects of past monetary policy action had yet to fully take hold, and hoped that pausing would give them more time to assess those lags and mitigate the risk of over-tightening. The pause was short-lived, however. By May, high and broad-based services inflation accompanied by a pickup in wage growth led the RBA to surprise markets with a 25bp hike. While the discussion of inflation was clearly more hawkish, markets figured that the move would not be followed up by another as the guidance around further tightening remained vague and emphasised the incoming data. We noted that the risk of inaction in June was high considering that labour markets had softened since, but bubbling inflation pressures and announced increases to wage awards and the minimum wage led us to take the non-consensus view that the RBA would follow up with another hike, a view that proved correct. Now, with the Cash Rate at 4.1% and the incoming data printing in a more mixed fashion, we think the RBA will join other DM central banks in intermittently pausing in order to have a better read on the economic landscape. This view is further supported by the frequency of the RBA's announcements. By announcing policy on a monthly basis as opposed to every 6-12 weeks like other DM central banks, the RBA has a greater ability to fine tune its hiking cycle during the final phases.

Reluctant hikers: If it isn't hurting, it isn't working

Whilst a failure to tame inflation might have led to the resumption of hiking by both the BoC and RBA, elsewhere it found central banks reaccelerating their hiking cycles, or elsewise tightening policy when they would really rather not. Most notable in this group was the Bank of England. Four upside CPI beats in a row has seen expectations for peak Bank Rate go from 4.8% immediately following the May policy meeting, to 6.2% now. This roughly 140bp increase in anticipated tightening was met in part by the BoEs 50bp rate rise this month. But the surprise reacceleration in tightening caught many off guard, with BoE speakers having strongly indicated that nothing beyond 25bp was being considered in the lead up to the meeting. With concerns growing over the state of the UK housing market and growth barely registering in positive territory, the risks of a policy induced recession loom increasingly large. But given that the body of evidence for a wage-spiral continues to amass, the BoE apparently felt forced to move without warning and with force. While we continue to view the market implied path for Bank Rate as too aggressive, we believe the BoE will have to take rates higher to at least 5.5% before sufficient upstream improvements in the inflation outlook begin to appear within the hard data, allowing the BoE to pause.

In contrast to the BoE, the Riksbank only delivered 25bp of monetary tightening in June. But even this came despite fears for a housing market that has already seen declines of 15% from the peak, and an economy projected to deliver a significant contraction this year. Admittedly markets had seen risks skewed to the upside, with a one-in-three chance that they followed suit with a jumbo rate hike of their own following an upside surprise to inflation. But given the grim economic outlook in Sweden, it seems likely that they would rather not have tightened policy at all. Another surprise CPI overshoot also saw the Norges Bank deliver a jumbo rate hike this month too. Headline CPI rebounded to 6.7% in May, despite expectations for price growth to keep trending in the other direction. This led the Norges Bank to overshoot market expectations with a 50bp hike this month. Whilst this will slow the Norwegian economy more quickly, the trade-off facing the Norges Bank is less pronounced, with growth conditions and the property market appearing to lie on a more secure footing than in either the UK or Sweden.

Pausers: But for how long?

The earlier commencement of the tightening cycle within emerging markets means that most central banks are now observing a sustained disinflationary process, enabling them to hold rates at their terminal levels. However, with inflation now seen as falling back to the target range or currently tracking within the central bank's preferred parameters, the prospect of easing policy back towards more neutral levels is on the horizon. This is most evident in Brazil, where markets now expect the first rate cut at August's meeting. Whereas in Hungary, where the effective policy rate is the highest amongst major EM central banks, falling inflation pressures have paved the way for emergency measures to be unwound.

"In the LatAm space, falling inflation and historically strong currencies have led expectations of policy easing to build."

This is most notable in Brazil, where the retrenchment of headline inflation back to target has caught the ire of government officials, leading to calls of policy easing. While the central bank held rates in June under concerns that inflation pressures are expected to return in 2H23, the mounting political pressure led policymakers to tone down their language and officially put policy easing on the table for August's meeting. Meanwhile, in Mexico, while rate cuts are anticipated before the DM easing cycle begins, they aren't necessarily a topic of discussion for Q3 given Banxico's consistent guidance that rates will be held at the current level for "an extended period of time" and their forecasts for inflation not to fall back to target until 2024.

Across the CE3 economies, policy rates were held constant again in both Poland and the Czech Republic. But the similarities between the two end there. Polish growth continues to outperform while inflation falls faster than expected, presenting a welcome gift for the NBP. The CNB in contrast faces the opposite problem, an economy that is failing to grow and inflation that looks decidedly sticky. In terms of policy stance, both banks have seemingly converged in recent months, with the NBP having given up much of its dovish bias. But a series of significant legal entanglements could yet prove the fly in the ointment for the Polish economy, as could political risk with a general election due later this year. Rounding out the CE3 countries is Hungary. Whilst strictly speaking still on pause, with the June policy meeting bringing no change to the official policy rate, the NBH used the meeting to continue trimming their emergency policy measures. They reduced the effective policy rate by 100 bps once again, in line with our call and analyst consensus. With June's meeting a copy and paste of that before it, the NBH has seemingly set out its stall for easing policy between now and September, when the emergency measures will align with the official policy rate.

Looking ahead

Looking ahead to 2H23, our expectation is that interest rate volatility is likely to grind lower in the coming months with more central banks opting to observe the transmission of previous hikes. The impact this will have on lowering the right hand tail of the rates distribution, and the limited signs of an impending recession also weighing on the left hand tail, is likely to result in most major bond yields trading within recent ranges. With rate differentials still a primary driver of FX markets, this is likely to lead to most major currency pairs trading within recent ranges too, although some differentiation within currency groups is likely based upon inflation dynamics, growth prospects, and financial stability concerns. In this environment, and with the US economy still ticking along at a steady rate of growth, we expect the dollar to remain supported above its year-to-date lows (100.82 on the DXY index). Towards Q4, however, as the blanket of fog covering the global economic outlook begins to lift as the transmission of 2022's hikes becomes more evident in the economic data, we expect volatility to pick up as rate cuts come back into view and for the US economic outperformance story to run out of steam.

"For the dollar, the main consideration is whether the US economy enters a recession, and if so, what the magnitude of the economic downturn is."

At present, we expect only a mild recession towards the end of the year in the US, leading the Fed to begin its easing cycle in 2024. As markets gauge the depth of the downturn, we expect the dollar to exhibit brief spells of risk-off inflows. Once the outlook for a mild recession takes form, however, we believe expectations for the Fed to begin the DM easing cycle will lead the dollar lower on a structural basis. As has been the case for much of the past year, risks around this outlook remain elevated and largely centre on the persistence of core inflation pressures and monetary policy induced recessions.

FX VIEWS

USD

Rangebound until the fog clears

While the dollar broadly weakened on the Fed's decision to hold rates at their June 14th meeting, it soon rebounded on signs of US economic exuberance, lingering concerns over inflation persistence, and slowing growth conditions in the rest of the world. Ultimately, these cross-currents led the dollar DXY index to mildly depreciate by 1.3% over the course of the month, with the index finishing the month just 8 basis points below our forecasted rate of 102.99. The dynamics on display in June highlight how downside in the dollar won't necessarily be smooth, a theme we expect to persist into Q3 as the incoming data is unlikely to display the full effects of previous tightening, thus leaving markets open to the prospect of a continuation in the DM hiking cycle and making it difficult to distinguish between a managed economic slowdown and more probable recession. As such, we expect late-cycle concerns to become more pressing in the second half of the year. This should keep the dollar supported on defensive positioning. Reflecting this, we expect the broad dollar to remain range bound throughout much of Q3 even as the prospect of a further rate hike from the Fed in Q4 becomes less viable. While we anticipate that the DXY index will trade in a range, the dollar's performance against the G10 is likely to be more bifurcated than the broad index suggests. Where we expect the largest moves to occur within the G10, is against currencies where late-cycle concerns are most pressing (SEK, GBP), and where valuations are stretched (JPY, NOK). The main risk to our broad dollar call over this horizon stems from the Bank of Japan. With JPY holding the second largest weight within the DXY basket, any immediate shift towards policy tightening from the BoJ will likely lead USDJPY to retrace from current levels, generating a larger decline in the DXY index than we have projected.

Towards the end of 2023 and the early parts of 2024, we expect the case for a structural decline in the dollar to be more clear cut, barring any resurgence in inflation that warrants a resumption in the DM hiking cycle. Under our base case scenario, the US economy begins to feel the effects of the past year's hiking cycle, culminating in a mild recession. Coinciding with narrowing corporate profit margins, this should see price pressures subside considerably, leading markets to price an easing cycle front-run by the Federal Reserve. Comparatively, in other DM markets, we don't necessarily think that economic conditions will warrant monetary easing until later in 2024, driven either by inflation persistence or growth resilience. Risks to this view are naturally tilted to the upside, with the dollar likely to benefit under a scenario where policy is in fact overly restrictive, thus resulting in deeper recessions and risk-off haven flows into the greenback, or where sustained inflation persistence induces another round of policy tightening by DM central banks towards the end of the year.

CNY

Testing tolerances

Weakness in China's economic recovery has been visible in data released across the entirety of June, with May's economic activity indicators at the beginning of the month causing enough concern to prompt earlier easing from the PBoC via a decision to cut the 7-day repo rate first by 10bps. While the decision to ease rates didn't obviously induce CNY weakness, largely because it occurred alongside a Fed pause, it was symbolic of the level of the level of concern amongst policymakers in achieving the 5% growth target. With US yields ramping up in the second half of the month and Chinese data continuing to underwhelm, pressure mounted on the yuan, leading the PBoC to reintroduce their countercyclical fixing. By setting the daily fix significantly stronger than market conditions warranted, the Chinese central bank signalled dissatisfaction in persistent CNY depreciation, a message that was ultimately followed up with more direct intervention as state banks were seen selling USD in markets in the final week of the month.

With the central bank now actively pushing back on market forces, we expect depreciation in CNY to ease, especially if the root cause of the problem, growth, is addressed via fiscal measures as alluded to by officials in recent weeks. While it will likely take a continued deterioration in economic data for Chinese officials to pull the fiscal lever, we think targeted support for the housing market and consumer will be CNY positive. Owing to the actions of the PBOC and the likelihood that US yields stay near current peaks, we look for only mild CNY depreciation in the near-term, with the recovery in the yuan likely over the 3-month horizon when more dovish Fed policy becomes likelier and stimulus measures take effect on indicators of Chinese growth.

JPY

Will they or won't they?

Standing out amongst the crowd, the Bank of Japan's dovish policy stance once again took full effect in FX markets. Even as front-end Treasury yields fell on a pause in the Fed's hiking cycle, the subsequent lower expected terminal rate boosted longer-term Treasury yields. This widened the US-Japan 10-year yield spread, inflicting renewed depreciation pressures on the yen. Once adjusted for the projected inflation rates, the widening in the yield differential was even more pronounced and was sustained across the entirety of the month. Despite this, however, the decline in the yen bottomed out around the 145 handle, as the BoJ's stealth intervention efforts of 2022 seemed to have a psychological impact in markets, aided by verbal jawboning from officials. While this time around conditions for intervention are different, owing to the slower pace of JPY depreciation and likelihood that the BoJ eventually tightens policy in the coming meetings, we believe this psychological barrier

will bind in markets. Whether in fact USDJPY ends the month significantly lower depends on the Bank of Japan's July 28th policy decision. We expect inflation conditions to prove robust enough for the BoJ to tweak its yield curve framework, most likely by widening the range in which the 10-year can trade around the 0% target. However, given the potential means with which the BoJ could effectively tighten policy, all of which having differing results on capital flows and thus the yen, the degree of uncertainty around our 1-month USDJPY forecast of 140 is elevated. Furthermore, there remains a risk that the BoJ doesn't yet believe the economy is capable of a structural inflation rate of 2%, as evidenced by Ueda's recent comments on underlying inflation, leading to another underwhelming BoJ decision. This would undoubtedly result in another sell-off in the yen, however, the pace of depreciation is likely to be more limited than in recent months given the recent emphasis of policymakers on the exchange rate. In the run-up to this month's meeting, we expect traders to express their views in the options space as opposed to spot markets, owing to the elevated degree of uncertainty.

EUR

1.10 remains out of sight in Q3

The single currency remains dictated by US-eurozone interest rate differentials. At the beginning of the month following a more hawkish ECB narrative and growing expectations of a Fed pause, the narrowing in front-end rate spreads stimulated a EURUSD rally and another test of the 1.10 level. However, with signs of softness in eurozone services appearing, and greater resilience in the US consumer boosting expectations that the Fed will take rates up to 50bps higher this year, rate differentials re-widened once again despite no change in rhetoric from either central bank. With the ECB highly likely to hike rates once again in July, following guidance from President Lagarde after the June meeting, and the Fed also likely to embark on another 25bp increase, we think the data will once again be the dominant factor for EURUSD in the near-term. On that front, we think eurozone and US data will be less divergent than earlier in the year. Amid a more benign growth outlook in the eurozone, we expect EURUSD to continue trading in its post-Fed range of 1.08-1.10. As such, we have partially revised up our one-month EURUSD forecast to be in the middle of this range. Over the medium-term, the fortunes for the single currency depend on whether the ECB is able to hike rates once again at September's meeting and whether US data will support a second hike from the Fed in Q4. Under our base case, neither transpire but for differing reasons. For the ECB, we expect growing recession and financial stability concerns will create a rift amongst the Governing Council, which will provide a binding constraint on the central bank's ability to raise rates to 4%. Meanwhile, for the Fed, we expect an improvement in the economic data will remove the need for further tightening. This should see EURUSD continue to trade close to but below the 1.10 handle, which we don't expect to see breached on a sustainable basis until year-end when rate cuts from the Fed come into view.

GBP

Higher rates aren't always a good thing

Sterling has continued to outperform through June, significantly overshooting our month end targets for GBPUSD of 1.25 and GBPEUR of 1.15. The cause of this strength has once again been climbing expectations for monetary tightening, with close to 100bp of additional rate hikes being priced in over the course of the month. However, with interest rate expectations shifting only modestly elsewhere, it is notable that sterling's rally has undershot that implied by the move in rates. This is largely due to the impact higher rates have on prospective capital returns for UK assets, with Bank Rate at the market implied levels widely seen as sufficient to induce a recession and raise broader financial stability risks. It is therefore understandable that the flurries of GBP strength over the course of June haven't necessarily coincided with the uprating in short-term interest rate expectations, but instead better growth data, which indicates that the UK economy is withstanding the higher rate environment better than anticipated.

> "In the short-run, we expect data on the state of growth and inflation conditions to remain the dominant factors for sterling as we believe the next month won't necessarily bring about a change in narrative from policymakers given the next BoE decision isn't scheduled until early August."

After all, it remains in the MPC's best interest to keep effective monetary conditions as restrictive as possible while the disinflationary channel forms. For this reason, the data is likely to be the determining factor for UK rates. On this front, upstream improvements in the inflation and labour market are likely to become more apparent after months of absence, while we also expect concerns over the state of the housing market and the retrenchment of the consumer to also weigh on terminal rate pricing. The extent to which this occurs in just one month's worth of data is likely to be limited, however, meaning the door will remain open to a second 50bp hike in August. The combination of lower terminal rate pricing and lingering risk of more hawkish near-term tightening should broadly offset one another in terms of the impact on the currency. However, with harrowing news over the UK housing market likely to keep sentiment depressed, we expect GBP to retrace at the margin. Reflecting this, we are rolling our one-month forecasts from June.

Further out, it is likely that markets will have to wait until after the August policy meeting for the data to uniformly turn, such that BoE policymakers can confidently push back on market pricing in a similar manner to earlier this year. For this reason we expect the BoE to hike Bank Rate to at least 5.50% in 2023, but for the peak to ultimately disappoint current market pricing of 6.2%. While

this would reduce sterling's carry appeal, we think the improvement in the UK's economic outlook under a lower and flatter trajectory for rates should be the dominating factor for FX traders, resulting in steady GBP appreciation against a backdrop of a broadly weaker dollar. Risks to our view are skewed to the downside, however. In particular the possibility of a housing market blowup is a significant source of concern, although this is most likely to be a 2024 story despite some grim mood music at present, where a general election will also increasingly come into scope for markets.

CAD

One more for the road

The Canadian dollar strengthened steadily throughout most of June, surpassing our 3-month target of 1.33 despite both BoC and Fed meetings falling in line with our expectations. The stage for the rally was set on the final day of May, when GDP data for the first quarter came in strong. As a result, markets swung in the direction of our view, namely that the Bank of Canada would end its pause and hike by 25bps on June 7th. Momentum dramatically accelerated on the first of June, but it was more of a weak US data story than anything to do with Canada. But as the BoC decision drew near, a growing minority of analysts joined us in our view that the data had strongly tipped the balance in favour of hiking, while market pricing also became more sympathetic to our base case. Indeed, on the 7th, the Bank met our expectations in surprising the consensus, noting that the weight of the evidence, which included sticky inflation, strong growth, rebounding housing, and fading banking system risks, no longer justified keeping rates steady. Afterwards, the consensus quickly shifted to expect further policy tightening, and rightfully so given the sharp hawkish pivot in BoC communications outside of an MPR meeting. Since then, however, the data has come in mixed. The job market witnessed its first net employment losses in months, although the headline was more bark than bite as core-aged employment still grew—the decline was largely the result of a slow start to the summer jobs season for students. Inflation fell on a headline basis, but dramatically overstated the degree of softening in underlying price pressures due to energy base effects. Meanwhile, GDP growth was flat, but driven by temporary factors like the public sector workers' strike. That's not to say it's all been mixed, with robustness in housing activity alongside retail, wholesale, and manufacturing sales, but the top-tier data no longer tell a crystal clear story about the economy's near-term prospects. For the loonie, while the more hawkish BoC expectations and dovish interpretation of the Fed meeting saw it break out of its nine-month range at the beginning of the month, the move was short lived as traders not only began to question whether a further hike was likely but also began to factor in stronger US data and the possibility that the Fed follows through on its forward guidance.

> "In truth, given the caveats in the data and the differences between headlines and underlying details, the Bank of Canada could, in a vacuum, make the case for either hiking or pausing in July."

It is no accident that economist expectations have not been so divided at any other point in this cycle. For us, however, the Rorschach-esque nature of the data means that the "story" is now front and centre, and the communications disaster that would result from flip-flopping back to a pause so soon is reason enough for the Governing Council to hike by 25bps again. It will also give officials peace of mind that, finally, this could be the stake in the heart that crushes sticky inflation once and for all. As the mixed nature of the latest round of data makes it increasingly likely that growth and inflation will become more subdued as we move into the second half of the year, we have grown more confident that the Bank of Canada only has one more hike in the tank, and will pause afterwards for the remainder of the year. Our rates view is thus above market expectations in the near-term, and slightly below it over a medium to long-term horizon. As we expect the price action in USDCAD to be mostly driven by interest rate differentials, and given that our expectations for the Federal Reserve are broadly in line with the market, we think that Canadian interest rates will have the greatest influence on the currency until it is clear that central banks are finished with hiking, which should keep CAD well-supported over the short term. Further out, while we anticipate soft-ish landings in both the US and Canada, we think the incoming macro data will make it hard to make that distinction in real time, potentially leading to sharp sell-offs in the loonie on each bearish data point. Nonetheless, over time, as the macro outlook becomes more navigable, a global recession narrative becomes relegated to the sidelines, and the Fed leads the DM easing cycle, we expect CAD to rally alongside other high-beta G10 currencies. As such, we anticipate a continuation in the CAD rally in the immediate term, before a slight sell-off towards the end of Q3, with a more structural rally pencilled in for 2024.

Scandis

A diverging story

The Norwegian krone did not quite hit the lows that we feared it would over the course of the last month, as the currency managed to find support from a surprise jumbo rate hike by the Norges Bank, and oil prices that remained range bound following a succession of declines in recent months. In contrast, the Swedish krona broadly met our bleak expectations, with EURSEK spending the second half of June charting record highs. Krona weakness came as anticipated, in response to a Riksbank that underwhelmed once again, whilst housing market concerns continue to concern investors. Given this, June was a month of diverging fates for NOK and SEK, a trend we expect to continue in the short run. Though neither central bank has a meeting this month, the Norges Bank looks set to keep hiking and whilst the Riksbank has indicated an intention to follow suit, it seems unlikely that they will ultimately be able to follow through on their guidance. In addition, Norges Bank FX sales were trimmed to 1.0b NOK per day at the end of June, which marked a significantly larger reduction than seen in previous month and should release some of the depreciation pressure on the Norwegian currency. Albeit, we also foresee that slowing global growth conditions will continue to weigh on both currencies, with the state of the Swedish housing market and an economy falling into recession also weighing on the Swedish krona. As such, we are marginally upgrading our short run forecasts for the krone, largely due to higher NOK rates and the reduced external pressures, while we are downgrading our projections for the krona by a larger margin. We see risks to our view as skewed to the downside for both currencies on a larger-than-expected slowdown in global growth and the possible increase in late-cycle concerns in both economies.

TRY

Further pain to come

In line with the market consensus, our expectations for TRY coming into June was for a continuation of the depreciation trend that took hold in the run up to the recent Presidential election. Indeed, we expected that a return to a more orthodox monetary policy framework would likely see this process accelerate. However, under the reappointment of President Recep Erdogan, we didn't think this policy shift would occur as quickly as it did. This resulted in a significant forecast error for our June projections. While we have seen the first peek at the CBRT's and finance ministry's plans to unwind the heterodox measures and rectify the economy, the implications for the currency moving forward remain highly unpredictable and dependent on the selected policy mix. Thus far, the decision by the CBRT's new governor Erkan to raise the repo rate by just 650bps to 15% while simultaneously relaxing other aspects of its lira-isation framework suggests the emphasis is currently on the lira to act as the stabilisation tool. This is the main reason why the lira has slumped 25% over the past month. While such actions could persist, leading to further sharp bouts of TRY depreciation, we believe the market reaction to June's decisions won't necessarily be dismissed by officials. After all, further TRY depreciation only places further pressure on the current account via gold imports and increased upside inflation pressures. As such, we expect future monetary tightening to be less underwhelming for markets, supporting the lira through this readjustment process. While this won't necessarily turn around the trend of TRY depreciation, it will mean that the fastest pace of depreciation is likely left behind in June. Under our base case, we expect USDTRY to follow its forward implied rate, ending the year 16.5% higher at the 30 handle. As expressed earlier, risks to this view are plentiful and largely tilt towards a greater sell-off in the lira under the scenario that Turkish officials continue to unwind capital measures that support the lira while not tightening monetary policy enough to provide a corresponding offset.

CE3

Hungary for more (policy easing)

Despite our expectation at the end of last month that the move lower in PLN was largely played out, the zloty managed to take another leg lower over the course of June. This followed central bank commentary that was modestly more hawkish than anticipated once again. But some dovish signs are beginning to re-emerge, with suggestions that 2023 rate cuts are returning to view. A dovish pivot should put a floor under EURPLN in our view, with PLN support from growth conditions meaning the cross is likely to trade in a range over the short to medium term. In contrast, the Czech koruna traded broadly as expected through June, but continues to remain range bound. The central bank has probably exhausted its ability to talk hawkish and tighten conditions that way. But despite stickier than expected inflation, weak growth should aid the central bank. As such we expected to see yet more of the same for now. The final CE3 country, Hungary, remains an outlier having already begun to ease monetary policy. Whilst we have not seen the degree of forint depreciation we had expected to see over the course of the month, we still expect this story to play out as the NBH further realigns the emergency policy rate with its more traditional measures while further rate cuts are eyed for Q4.

LatAm

BRL at the forefront of EM currencies

Over the last month high real rates have continued to feed the markets' appetite for Latin American carry. Together with hawkish monetary policy stances and still solid fundamentals in the form of incoming data, both MXN and the BRL have continued to trade at recent highs. In the case of MXN, the last month has seen the currency trade modestly higher, especially in the second half of the month, in an environment where domestic economic events have been largely muted for markets and the Federal Reserve's June pause has seen the gap in real rates remain static in the past month. However, the BRL has not only put an end to the outbreak of depreciation with which it

started the month, but has also experienced one of the most significant bouts of strength against the US dollar, not only in the LatAm region but emerging markets as a whole, surpassed only by COP.

For MXN, the risk backdrop during the first part of the month and the market's assessment of the US growth outlook have largely driven the currency pair. With the prospect of a US recession seemingly ruled out, especially after the solid upward revision of GDP growth in the first quarter, coupled with Mexico's economic fundamentals showing sustained strength in terms of solid growth and continued disinflation, the Mexican peso has remained sustainably below the 18 level over the past month. However, we remain cautious on strong positioning, given the possible exhaustion of the improvement in Mexico's real rate profile and the albeit limited view of further US rate tightening. This leads us to believe that the USDMXN may continue to trade at multi-year lows in the near term, although the pair is unlikely to probe new depths. While unlikely to occur until Q4, the start of Banxico's easing cycle is likely to result in MXN depreciation, especially if it coincides with the start of a mild US recession as is our base case. With markets currently pricing the least amount of cuts from Banxico, further MXN downside could occur should the deteriorating growth backdrop prompt more aggressive easing expectations. Ahead of this, we believe the possible resumption of the Fed's hiking cycle will result in a slight upward correction in USDMXN, while saturated positioning heading into a LatAm easing cycle may also prompt some profit taking.

"In Brazil, the more benign global market backdrop, improvement in real yields, and cheaper valuations led traders to flood into the real over the course of June."

The improvement in sentiment around the BRL would be further reinforced by the upgrade of the external debt outlook of the S&P rating agency from "stable" to "positive". Against this backdrop and with the prospect of a BCB easing as early as August, the focus returns to domestic developments. With relations between the Brazilian government and the central bank souring in recent weeks, especially after the public spat evident around the BCB's latest decision and its subsequent intensification following the publication of the minutes, only optimism over the approval of the fiscal framework in the Senate has been able to keep the domestic outlook in Brazil positive. The incessant calls by different members of the Brazilian government for cuts in the Selic rate or, ultimately, for an upward revision of the medium-term inflation target, have continued to be the main source of political noise in the country. All the more so following the most recent rate decision in which almost all hard-line rhetoric was maintained where, despite constructive inflation developments and almost a year with the Selic rate at 13.75%, the BCB again urged caution, pointing to the costs of having to resume its hiking cycle as some major central banks have had to do in recent weeks. However, we believe that the possibility of the BCB having to resume its hiking cycle is unlikely. Although the decision to hold rates was taken unanimously, the change in the perceived tone on the day of the decision compared to what we saw in the published minutes could indicate a certain diversity of views within the Bank's Monetary Policy Council, something that also caught the attention of the Executive, who would summon Governor Campos Neto to provide clarifications to the Senate if the August rate cut cycle did not start. While we believe a rate cut in August is premature given the BCB's concerns over returning inflation pressures in 2H23, our conviction in this call is low.

As for the impact of a possible easing by the BCB from August onwards, there are currently conflicting views. On the one hand, easing is likely to take place amid a peak in US rates and relatively low levels of inflation relative to the nominal level of interest rates. Thus, Brazil's real rate profile is likely to remain supportive of capital inflows in a more benign global market environment. On the other hand, however, the nominal interest rate cuts follow the best consecutive four quarters for the long carry trade in Latin America, as measured by Bloomberg, so any surprises in the BCB's easing cycle are likely to cause a significant positioning shock. Given Brazil's steadily improving inflation outlook and renewed pressure from government authorities, we expect the risks of such a move to be relatively high, so we expect to see further BRL weakness in the next three to six months. However, in a context of more stable DM rates, possible Chinese infrastructure stimulus, which should boost Brazil's terms of trade, and the possibility of a more resilient BCB, the real could have more room to run on a more tactical horizon.

Forecasts

Currency Pair	1-month 31st July 2023)	3-month (30th September 2023)	6-month (31st December 2023)	12-month (30th June 2024)
G10				
EUR/USD	1.09	1.09	1.10	1.12
USD/JPY	140	138	130	130
GBP/USD	1.25	1.25	1.26	1.28
USD/CHF	0.90	0.90	0.91	0.91
USD/CAD	1.32	1.3	1.34	1.3
AUD/USD	0.67	0.69	0.695	0.71
NZD/USD	0.62	0.62	0.63	0.64
USD/SEK	11.0	11.2	10.7	10.0
USD/NOK	10.6	10.5	10.0	9.5
DXY	102.8	102.5	101.2	99.4
Emerging Markets				
USD/CNY	7.25	7.2	7.0	6.8
USD/INR	82	83	81	80
USD/SGD	1.34	1.35	1.33	1.33
USD/ZAR	19	20	20	18
USD/TRY	26.5	28	30	34
USD/PLN	4.08	4.08	4.00	3.93
USD/HUF	349	358	364	366
USD/CZK	21.6	21.6	21.8	21.9
USD/BRL	4.9	5	5.1	5.15
USD/MXN	17.3	17.5	17.75	18
Euro Crosses				
EUR/GBP	0.87	0.87	0.87	0.88
GBP/EUR	1.15	1.15	1.15	1.14
EUR/CHF	0.98	0.98	1	1.02
EUR/CAD	1.44	1.42	1.47	1.46
EUR/SEK	12	12.2	11.8	11.2
EUR/NOK	11.6	11.4	11	10.6
EUR/TRY	28.9	30.5	32.5	38.1
EUR/PLN	4.45	4.45	4.4	4.4
EUR/HUF	380	390	400	410
EUR/CZK	23.5	23.5	24	24.5
EUR/BRL	5.34	5.45	5.61	5.77
EUR/MXN	18.9	19.1	19.5	20.2

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