FX Forecasts

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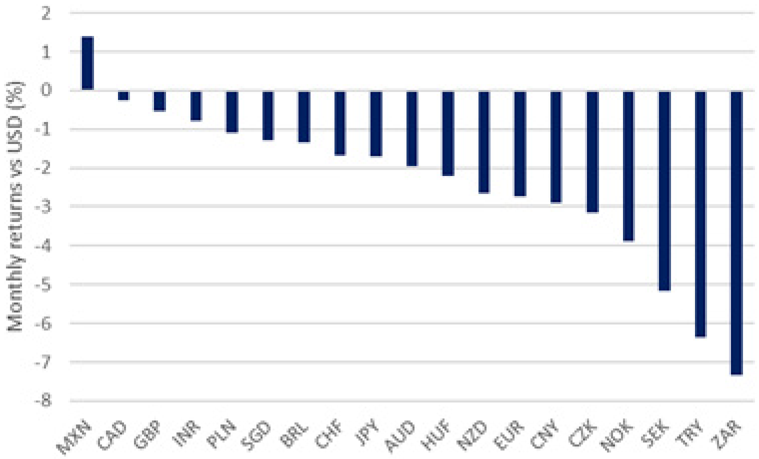
INTRODUCTION

Staying in range

Market price action over the past month was dominated by the twin themes of political dysfunction and economic convergence, both of which played into the hands of the dollar. In the case of the former, it was the US debt ceiling that really stole the show, with the dollar reaction washing through FX markets like a tidal wave towards the end of the month. But EMs also had their fair share of drama, with the Turkish lira and South African rand notable standouts on local political developments. However, with the debt ceiling deal all but rubber stamped, it is the second trend that we see as likely to continue as a driver for markets over coming months, especially in the G10 space. Many developed markets now appear to be converging on a state of stagnant economic growth, robust labour markets, sticky inflation and rates that will likely stay higher for longer. This dynamic has seen currencies that have outperformed in recent months on expectations of economic exceptionalism trim gains, such as the euro and the yuan. In comparison, relative underperformers have clawed back some losses, albeit on a trade-weighted basis as opposed to against the dollar. Continued economic convergence and the approaching end of monetary tightening might suggest some calm in markets, ripe for a "sell in May and go away" scenario to play out over the summer. As has been the case in the past three years, however, we don't expect a quiet summer in markets, largely due to the still elevated level of macroeconomic uncertainty. Nonetheless, we do expect the level of economic convergence to result in most currency pairs trading within year-to-date ranges.

The dollar broadly rallied over the course of May, with fellow North American peers also outperforming



Monetary policy is likely to be in the driving seat in terms of volatility again next month as markets will receive a fresh round of policy decisions from major central banks. For most, including the Federal Reserve, monetary policy is in a precarious position: previous policy actions are yet to weigh significantly on inflation such that policymakers can take confidence in the disinflationary channel and ignore any signs of potential inflation persistence, while the threat of a delayed rather than reduced transmission of past hikes means that each additional hike increases the risks of overtightening and the negative economic consequences thereof. Owing to this, we expect most central banks to steer clear of explicit forward guidance by maintaining their commitments to data-dependency, but for some including the ECB and the Federal Reserve, fresh forecasts will need to be provided. This should give markets some indirect guidance on the path for rates, especially as economic economic conditions have altered significantly since the last projection round. In addition to the monetary challenges, markets will also have to contend with a likely spike in Treasury issuance as the Treasury General Account begins to be replenished with cash and continued signs of instability in European real estate; the latter providing a timely reminder that financial stability worries from a few months ago haven't completely dissipated.

Crisis avoided, damage done

The inescapable story of the past month was the psychodrama that was US debt ceiling negotiations, which led markets on a wild ride and contributed to the DXY index's 2.6% rally on the month. Having previously indicated an X-date of June 1st, Treasury Secretary Janet Yellen pushed this back to June 5th just prior to the initial deadline, giving time for negotiations between President Joe Biden and Republican House Speaker Kevin McCarthy to be finalised. Whilst not yet signed and sealed, the deal which was announced on the 28th of May should be able to reach President Biden's desk before this final cut-off, just narrowly avoiding a default. Surprisingly given the level of political posturing in recent weeks, the deal ultimately appears to have been agreed with minimal concessions from Democrats, with discretionary spending due to be capped at current levels in 2024 and rise by 1% in 2025.

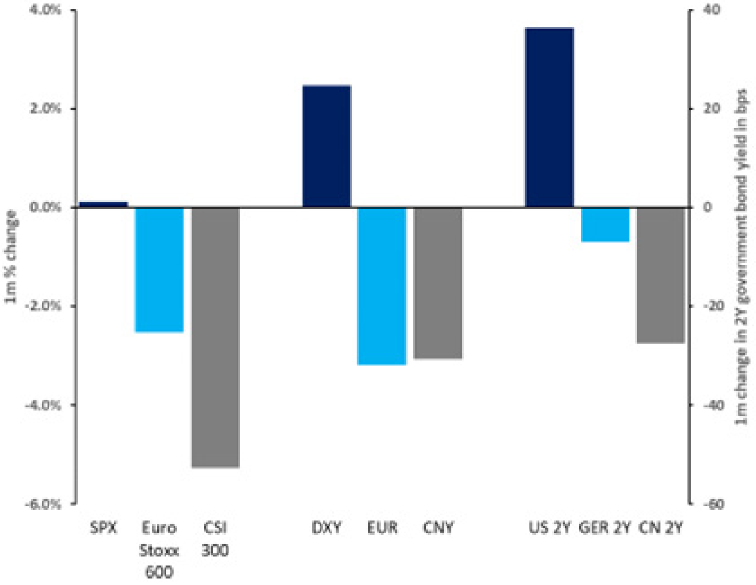
> "With all that said, and almost done, markets will likely be breathing a sigh of relief as the prospect of a US default and the ensuing market turmoil now fall away."

Short term, when compared with the range of scenarios that a breach of the debt ceiling would have entailed, this is unambiguously good for the US economy. With data also pushing back on previous recession concerns, the avoidance of a negative growth shock from default has led the dollar to hold onto the bulk of its initial haven bid. Longer-term however, this latest crisis has highlighted US political dysfunction once again, a worrying concern for investors with the 2024 Presidential election cycle now starting to heat up. From a more fundamental macroeconomic perspective, despite implying some cuts in spending in real terms, this deal also did nothing to address the enormous deficits that the federal government continues to run. These are especially alarming given the elevated level of government borrowing and current level of interest rates. Therefore, despite some short-term relief for markets, an environment of unsustainably large deficits and political turmoil is likely to weigh on the US economy all else being equal. Alongside rich valuations and the perennial dedollarisation argument, this adds weight to the structural case for USD depreciation, although the emergence of which is likely to occur over a longer time horizon.

Not so special after all

Despite being outshone by the debt ceiling debacle in terms of media coverage, one of the primary drivers of the dollar rally in May was weaker activity data out of China and Europe alongside signs that the US consumer remained in a healthy position. The combination of which led markets to reassess the "divergence" trade; a dominant driver of Asian and European FX outperformance up until May. With the US economy no longer viewed as teetering on the edge of a recession and both the Chinese and eurozone economies growing at a slower pace than initially forecast, the convergence in economic profiles resulted in US equity outperformance, fewer rate cuts being priced for the Fed this year, a re-widening in rate differentials, and a broadly stronger dollar.

Markets repriced the European and China vs US divergence trade in May across all asset classes



The most significant repricing came in the form of China's growth profile, which was heavily downgraded by most forecasters after April activity data showed signs of broad-based weakness. The data was so concerning that the PBoC started to inject more liquidity back into the system, a precursor for monetary easing. We now expect the PBoC to double down on their level of support by cutting Banks' required reserve ratio (RRR) in June and potentially even lowering the 1-year MLF rate in H2 2023, especially as the initial signs of economic weakness were recently compounded by the NBS PMIs for May. The weaker growth outlook and reduction in Chinese rates was priced into Chinese assets in real time, leading the yuan to fall 2.4% over the course of the month. Despite the relatively hefty losses, it wasn't necessarily the magnitude of yuan weakness that stood out, but instead the significant levels that were broken along the way and the lack of pushback from the central bank via its daily fixing.

> "Meanwhile in Europe, weakness in manufacturing and evidence that core inflation was starting to turn weighed on the euro as market pricing of the ECB's hiking cycle struggled to keep pace with the removal of rate cuts from the Fed's implied path."

Industrial production, factory orders, and even the flash May PMIs showed broad-based weakness within the eurozone manufacturing sector, which began to filter through into core inflation as April's data showed non-energy industrial goods prices falling from 6.6% YoY to 6.2%. At the end of the month, traders betting on a flatter rate path in Europe were vindicated as May's inflation data confirmed that core inflation did in fact peak in March. More importantly, the data showed that core inflation conditions in the eurozone were starting to cool in a broad-based manner, with services inflation also turning a corner.

By way of contrast, data out of the US surprised to the upside, led by signs of resilience amongst the consumer. This was visible across both hard and soft aggregate data as well as anecdotal evidence on a micro level. Combined with limited slack in the labour market and signs that the disinflation process amongst core items was beginning to stall, markets were forced to price out rate cuts from the Fed this year while they also began to speculate on further hikes. This resulted in the yield on the US 2-year to rise 29bps on the month, widening spreads with both the eurozone and China. Over the course of the month, the US-German 2-year spread widened 38bps to 1.72%, the widest the differential has been since the onset of the regional banking crisis in mid-March, and the spread against the Chinese 2-year to widen by 61bps. This, along with relative underperfomance in European and Chinese equity indices, led to significant depreciation in the euro and the yuan.

Not all economies are converging, however

Slower growth in China and Europe and US economic resilience underscores one of the other major themes within the global economy right now. That is, economic convergence. Most major developed markets are now exhibiting signs of slow or even stagnant growth, tight labour markets, disinflation in headline and in some cases core inflation, and central bank's that are at or close to their terminal rate. But that isn't the case for all economies, not even within the G10.

The prime example of the outliers is the UK, where despite signs of relatively slow growth and limited slack in the labour market, an unexpected acceleration in core inflation in April led Bank Rate expectations to skyrocket with more than four additional hikes priced. While yields generally had a positive correlation with currency strength in May, the higher expectations actually weighed on sterling. This is largely because if fulfilled, Bank Rate at that level would almost certainly tip the UK economy into recession, weighing on the prospective outlook for UK assets.

Also standing out as an exception to the rule is the truly unique case of Japan. May saw inflation rise yet again, led by core inflation climbing from 3.8% to 4.1% YoY, but expectations for exiting yield curve remained suppressed as a result of commentary from the BoJ maintaining the typically dovish tone. In the context of climbing nominal rates across core economies and lower inflation elsewhere, the combination of dovish rhetoric and rising inflation pressures saw the yen sell off strongly over the course of the month as the spread in real yields with the US widened once again. A similar story also saw SEK take a beating over the course of the month as rate differentials with the eurozone widened. This follows the Riksbank's late April meeting, where they abandoned all pretence of trying to sound hawkish, and acute concerns over the Swedish real estate market becoming visible in listed CRE companies.

> "Whilst most countries are still busy raising rates and tightening policy, the CE-3 economies have once again provided an outlier."

In this case it was Hungary, where the central bank became the first to blink as far as monetary policy is concerned, cutting the effective rate by 100bp on May 23rd. Whilst the theme across CE3 had been one of convergence with the NBP becoming increasingly hawkish, closing the rhetoric gap to a CNB and NBH where dovish hints were progressively growing, the policy easing by the NBH has fired the starting gun on an easing cycle that should now see growing divergence in coming months.

Local political stories also played a role in EM

Across emerging markets, political risk was the key driver across major currency movers over the past month. Standouts in May were Turkey and South Africa where both the lira and the rand sold off to record lows respectively. For Turkey, it was a presidential election that was front and centre, with incumbent President Erdogan being forced into a runoff vote, before securing an ultimate victory on May 28th. Given the unorthodox monetary policies he favours, FX markets did not take Erdogan's victory as a positive sign, even as his comments suggests a U-turn in the economic framework is imminent. In South Africa on the other hand, May saw government figures picking political fights with the US over allegations of supplying weapons to Russia, yet more trouble at state energy provider Eskom, and a policy decision from the SARB that underwhelmed market expectations. This combination not only saw the Rand weaken but led USDZAR to surpass even its early Covid period highs.

FX VIEWS

USD

Conservative Fed to restrict USD breakout

Our May forecasts foresaw a slight, yet bumpy, downtrend in the broad dollar in the near-term, primarily on the basis of mediocre growth in the US vs Europe and Asia and minimal risks of broad risk aversion in markets. In effect, this would have seen the dollar trade in the middle range of the dollar smile, exhibiting neither haven demand nor dramatic portfolio inflows. However, we noted that this path lower for the greenback was narrow and was mired in upside risk, primarily over the 3-month horizon. What we didn't expect was for these risks to materialise as quickly as they did, especially with respect to the economic divergence trade. Our view was that if markets were to substantially unwind positions built on this narrative, they'd need multiple rounds of data. Furthermore, we viewed further rate hike from the Fed as early as June as being improbable, especially given policymaker's concerns over delayed monetary policy transmission. In actual fact, it took just one month's worth of data showing core services disinflation in Europe, a broader based slowdown in Chinese growth, and economic resilience in the US for markets to neutralise this positioning and for bets on a June rate hike to build. We think this repricing will retrace somewhat over the coming month.

While we're mindful that limited slack in the labour market and a more resilient consumer backdrop pose risks of inflation persistence, we think markets have gotten too ahead of themselves in terms of Fed pricing. In our view, markets are placing too much emphasis on the incoming data and are underappreciating the Fed's desire to better observe the transmission of previous hikes. The latest comments by Fed Chair Powell and Vice Chair nominee Jefferson support this view. If the Fed is to raise rates to a higher terminal level, we think it is more likely to occur at the July meeting. In isolation, this should weigh on the dollar at the margin as the probability of a June increase is priced out. From a monetary policy perspective, the main risk in June comes in the form of the Fed's dot plot, which given recent data is likely to be revised up.

> "With the level of macroeconomic uncertainty still elevated, however, we don't expect the median dot to be revised up more than 12.5bps, indicating a roughly equal risk that the hiking cycle is resumed."

The dollar's buoyancy in May wasn't just due to the hawkish repricing of the Fed, although this was a key facet of the rally. A lack of prospective capital returns elsewhere also fuelled inflows into US markets, especially given strong idiosyncratic stories within US equities. As mentioned in our euro section, we think markets have also overextended on pricing out the positive growth story in the eurozone following recent manufacturing data and signs of cooling in China's economy. Although it is only likely to be a tertiary story, our expectation of a slight rebound in the euro in June should also weigh on the broad dollar.

While our near-term view on the Fed is more dovish than money markets and our medium-term dollar view remains structurally bearish, we don't necessarily expect the greenback to significantly weaken in the near-term. The prospect of a higher terminal rate and the potential for rate cuts to still be priced out for this year should keep the dollar well supported on the back of stronger US data, leaving most major FX pairs rangebound. Over the 6-to-12-month horizon, however, we do expect structural factors to bind, leading to a cleaner and faster decline in the broad dollar index.

EUR

Redemption trade

After touching a fresh one-year high just shy of 1.11, the euro spent most of May declining against the dollar, with weakness against the pound also becoming more prominent towards the end of the month. Driving the euro's decline initially was the ECB's acknowledgement that monetary policy had effectively been transmitted into tighter credit conditions, which stalled the upwards momentum in eurozone rates. Weakness in hard manufacturing data then compounded the euro's decline, but ultimately it was a broad-based negative surprise in China's activity data that did the damage, leaving markets to unwind positioning from the divergence trade. Towards the end of the month, data showing that core services inflation was beginning to cool added the icing to the cake. This led money market traders to price out 10bps from the ECB's implied terminal rate at the same time rate expectations for the Fed continued to drift higher. The re-widening in the eurozone-US yield spreads as a result underpinned much of the EURUSD weakness over the course of the month.

However, similar to our view on market pricing of the Fed, we think money market traders have overreacted to eurozone developments in May. Conditions in the eurozone scan as similar to the US in December, where initial signs of disinflation within core measures led markets to price fewer rate hikes and sell the dollar.

> "Given the US economic cycle has led that of the eurozone by just over a quarter thus far, we expect that sustaining the decline in core CPI will be much more difficult in the eurozone than markets are currently discounting."

Commentary by ECB officials in recent days speaks to this, with President Lagarde stating that the hiking cycle needs to be continued until the ECB are "sufficiently confident that inflation is on track to return to target". In our view, the ECB is still likely to hike the deposit rate to 3.75% by July's meeting, while risks of an extension to the hiking cycle are higher than markets are currently pricing. In addition to our view that the Fed will underdeliver on market expectations at their June meeting, this should lead to eurozone-US rate compression and support a partial retracement in EURUSD in the short-term. Over the 3-to-6-month horizon, we now believe the euro will struggle to break consistently above the 1.10 level largely because of slower growth conditions both domestically and in China. Risks over this horizon are tilted to the downside and are generally comprised of higher front-end Treasury yields on more persistent inflation pressures, and further downward revisions to China's growth profile.

GBP

Sterling set for a quiet summer

Moves in sterling over the course of May were led by significant shifts in Bank Rate expectations. Coming into the month, markets anticipated a terminal Bank Rate of between 4.75% and 5%. Data in the early in May did little to push back on this narrative, with markets unperturbed by a dovish sounding Bank of England. As such, OIS implied pricing for terminal Bank Rate spent much of the month drifting higher, a move that was initially positive for the pound. This offered support for sterling against a wave of dollar strength in early May and brought an uptick against a euro hamstrung by market expectations for the ECB to underdeliver. However, debt ceiling concerns ultimately led cable lower through the middle of May, whilst GBPEUR was left treading water as markets began to buy into a raft of hawkish rhetoric from the ECB.

Towards the end of the month, Bank Rate expectations were turbocharged by hotter-than-anticipated April CPI data, published on May 24th. The data at one point led money markets to price more than four additional hikes from the Bank of England this year. This shift in expectations flipped sterling dynamics on their head, where increasing rate expectations have a negative impact on the growth outlook, raising risks around the UK housing market and hurting UK investability to a degree sufficient to outweigh the attraction of higher rates. Therefore, Bank Rate expectations drifting lower at the end of May were actually supportive of sterling, with the pound rallying strongly against both the euro and the dollar. But with 80 to 90bps of tightening still anticipated by markets, the drift lower in expectations is in our view now approaching a point where this reversed dynamic peters out.

> "Under our expectation that the BoE won't hike rates beyond the next meeting, and a corresponding dovish repricing in US rates, we expect that GBPUSD is likely to trade in a range over coming months."

Driving our more dovish view on the BoE's policy path is positive developments in the labour market, exemplified by the unemployment rate increasing from a bottom of 3.5% in August last year to 3.9% in March. Moreover, payrolled employees fell by 136k in April and forward-looking indicators such as the REC survey on jobs have also pointed to a cooling job market. With the BoE due to meet at the end of June, we expect a 25bp hike to be caveated with a further reiteration of the Bank's data dependent stance in line with broad consensus. But signs of a slowing labour market and delayed disinflation pressures are likely to translate into falling core inflation in coming months. This should lead the BoE to ultimately undershoot current market pricing, although realising a terminal rate of 4.75% is in our unlikely to be to move sterling outside current ranges.

CAD

All eyes are on the BoC

Recent data out of Canada has presented a compelling case for the Bank of Canada to resume its hiking cycle or else risk persistent inflation pressures becoming embedded. April's headline inflation rate ticked up slightly from 4.3% to 4.4% YoY, while the BoC's previously preferred measures of timely core inflation pressures have remained stuck around 4% in recent months. Furthermore, the Canadian economy outperformed the Bank's upwardly revised Q1 growth forecasts, projections suggests that strong growth momentum has persisted into Q2, all the while the labour market remains historically tight. While an off-consensus view, we believe the case for the BoC to hike in early June is credible and stands in contrast with a Federal Reserve that has more reason to hold rates. In addition to a likely bottom in global oil prices on OPEC's intention to cut supply further and signs that the US economy is more resilient than initially expected, should the BoC fulfil our expectations, USDCAD is likely to fall to its Q2 low of 1.33. However, there is a non-negligible risk that BoC decides to hold rates, albeit with hawkish guidance, due to all of its communication channels not being active at the June meeting and the Federal Reserve signalling a preference to conditionally pause. As such, our one-month forecasts present a much more conservative view of 1.34, but we note that the balance of risks is to the downside.

CNY

A more orderly decline

Price action in USDCNY was largely dictated by widening front-end yield spreads. Initially driven by the pricing out of Fed rate cuts, the move higher in the interest rate spread was accelerated by data that suggested China's economy was slowing at a much quicker rate and in broader terms than markets had anticipated. This not only led to increased levels of liquidity provision by the Peoples Bank of China, but mounting expectations that more formal easing measures are imminent in the way of RRR cuts and potentially even a reduction in the 1Y MLF rate. While the pace of depreciation in the yuan was notable, the lack of resistance from the central bank in the way of its daily fixing was more significant. Ultimately, it took until the pace of CNY depreciation really stepped up on the week ending May 19th for the PBoC to issue its first verbal intervention. Nonetheless, with data continuing to compound concerns over China's growth profile, highlighted in weak CPI data and official PMIs for May at the end of the month, weakness in the yuan persisted as markets diversified away from the regional growth story in Asia. With all indicators pointing towards policy easing in China and continued slowdown in the pace of recovery, we expect further upside in USDCNY in the short-term. However, the aggressive reaction in USDCNY over the past month and the shot across the bow from the PBoC mid-May warrants caution in chasing this move aggressively higher. We have adjusted our forecasts slightly above the mark-to-market rate to reflect this. Over the medium-term, we expect China's economy to once again outperform, owing to the looser level of monetary policy over the post-pandemic phase and the lack of inflationary pressures. This, alongside reduced core rates and rate volatility, should enable USDCNY to recover below 7. The extent of the recovery depends on the pace in which growth is projected in 2024, however.

TRY and ZAR

In uncharted territory

Political risk and deteriorating economic fundamentals have been front and centre for investors exposed to Turkey and South Africa over the past month, with both respective currencies depreciating significantly to hit fresh record lows. While the local stories are vastly different, we think the outcome for the lira and the rand is likely to be the same. That is, further depreciation in the near-term, at least until economic fundamentals begin to rebalance.

In Turkey, the prospect of returning to a more orthodox economic framework even under another Erdogan Presidency has led to increased hedging demand amongst offshore participants, forcing USDTRY above the 20 handle. While we had previously pencilled in sustained TRY depreciation, our base case foresaw such a move only over the three-month horizon. This was driven by our view that under an Erdogan re-election, the normalisation of policy would be much slower. However, recent messages out of Ankara suggest that the return to an orthodox monetary framework will be much swifter than we had imagined, leading us to revise up our near-term USDTRY forecasts. While we believe sharp and sustained lira depreciation is in store, uncertainty over how quickly the return to orthodox policymaking will be and to what extent the central bank of Turkey will be able to offset depreciationary pressures in the short-term means our conviction in our near-term forecasts is low. Additionally, the pace of which the economic framework is reset is also fundamental for the medium-term outlook given its influence not only on the pace of lira depreciation and inflation, but also investor confidence in Turkey's commitment to re-open to foreign investors.

> "The South African rand finds itself in similarly unchartered waters after further announced loadshedding by Eskom, diplomatic disputes with the US, and an uninspiring SARB decision led the currency to repeatedly hit fresh record lows."

With South Africa's economic fundamentals weak, key trading relationships strained, and the SARB's ability to raise rates to stabilise the currency restricted by the possibility it causes a negative feedback loop, price action in USDZAR is likely to remain one-directional for much of June. However, given our view that US rates have likely found a temporary top under our base case of a Fed hold in June, the pace of depreciation is likely to slow in the near-term. We therefore look for USDZAR to trade around 20 over a tactical horizon, with depreciation likely to become more pronounced over the 3-month horizon should the Fed re-engage with rate hikes and China's economic data pose further risks to the government's 5% 2023 growth target.

Scandis

More headwinds on the horizon

Despite our expectation of continued Scandi FX weakness in May, SEK depreciated particularly faster than we had forecast on brewing domestic stability concerns, deteriorating terms of trade, and an overall high beta to global risk conditions. This more than offset the positive influence of more dovish ECB expectations.

In Sweden, the krona has been hurt by the perceived inability of the Riksbank to increase rates as rates in other key markets have generally risen, albeit to a lesser extent in the eurozone. This has been further exacerbated by markets that are no longer buying into hawkish rhetoric from the central bank as supportive for the currency. Whilst this approach was largely junked following the policy meeting in late April, some half-hearted attempts over the course of May have been flatly ignored. What we had not antiquated, however, is the extent to which concerns over the property market would begin to come to the fore. In particular, the share price of major Swedish landlord SBB has fallen by almost two thirds this month as the impact of higher borrowing costs continue to be felt. Dragging much of the Swedish property sector along for the ride, this has refocused attention on financial stability risks and piled further negative sentiment on the outlook for SEK.

Norway in contrast, whilst not suffering quite the same level of property market concerns, has instead been subject to the double whammy of high FX purchases and falling oil prices. With Norges Bank sales of NOK already disappointing market expectations at the beginning of April, coming in at a greater than expected 1.4b per day, the rate of FX purchases for June which were unveiled on the last day of the month revealed only a slight fall in the speed of sales. Coming in at 1.3b per day, this once again undershot the levels markets were looking for and led to a renewed sell off in the krone. Adding to this depreciation pressure, oil prices which have fallen by over 10% over the month have contributed a further downward impetus for NOK. In this context, and in a country highly exposed to imported inflation, the central bank might be expected to attempt to offset currency weakness with higher interest rates. In Norway though, the Norges Bank underwhelmed here as well. Despite raising interest rates by 25bp in line with consensus expectations, this is too modest an increase to be supportive of the currency when considering the degree of monetary tightening expected elsewhere, especially from the ECB.

Looking forwards, despite the debt ceiling crisis seemingly having been resolved, yet more weakness looks likely across Scandi FX. Whilst a retracement of recent dollar moves and an improvement in risk conditions following the debt ceiling resolution should provide some support for both NOK and SEK, these are likely outweighed by domestic concerns as directional catalysts for both currencies. In Sweden, recession concerns and the state of the housing market are unlikely to ease any time soon and may well become more acute over coming months. For Norway, it appears likely that falling oil prices and high levels of FX purchases will continue to weigh on the Krone. In both cases, slowing global growth and domestic central banks that are unable or unwilling to catch up with the ECB will add to the depreciation pressure in the short term, but with risks that the Norges Bank in particular could offer more support given better domestic growth conditions. In summary, this suggests more pain ahead, albeit probably materialising at a slower pace than in May, and we are downgrading our forecasts SEK accordingly whilst carrying forward last month's NOK projection.

LatAm

MXN to outperform BRL on quieter political backdrop

With high and improving real rate profiles, both MXN and BRL have traded close to or at multi-year highs throughout the course of the past month. While we expect that dynamic to persist with the Mexican peso over the near-term given the economy's relatively robust economic fundamentals, exposure to a more resilient US economic outlook, and continued improvement in its real rates, we expect the recent bout of BRL depreciation to persist. This is likely to be driven by further delays in the approval of the government's fiscal plan by the legislature, a deterioration in its terms of trade due to slower Chinese growth, and the prospect of renewed tensions between the central bank and the government.

> "Since the emergence of US regional banking risk, local developments in Mexico have taken a back seat."

Instead, global risk sentiment and the market's assessment of US growth prospects have largely driven the currency pair. With the prospect of a US recession now seemingly off the table and financial stability concerns slipping onto the back burner, alongside Mexico's economic fundamentals showing sustained strength in terms of solid growth and continued disinflation, the Mexican peso has sustainably broken the 18 level over the past month. While we are cautious of heavy positioning, the continued improvement in Mexico's real rate profile and our expectation of limited pressure from rising US rates leads us to believe USDMXN will continue to trade at multi-year lows in the near-term. However, the prospect of an extension in the Fed's hiking cycle in Q3, the limited possibility of further rate hikes from Banxico, and crowded long MXN positioning is likely to restrict USDMXN from plumbing fresh lows. Over the medium-term, we expect Banxico to begin easing, most likely in Q4. This should remove one of the main sources of MXN appreciation, especially if the decision isn't met with similar actions from the Fed. Risks to our near-term forecasts are titled to the upside. These largely take the form of an earlier-than-expected hike from the Federal Reserve, any resumption in nationalisation efforts by the AMLO administration, which will naturally weigh on investor sentiment, and a sharp unwind in long MXN positioning on an unexpected deterioration in risk sentiment.

In Brazil, as mentioned above, the story is somewhat different. Domestic developments continue to have a larger influence on how the real trades, and while the economy's fundamentals remain solid, some of the shine has been taken off by recent signs of soft Chinese growth. On the local front, issues such as the delay in the approval of Lula da Silva's fiscal plan in the upper house, the President's "dream" of a common currency among the BRICs, and recent memories of strained relations between the BCB and the government over maintaining tight monetary policy continues to weigh heavy on the real. These are precisely the factors that we continue to highlight as downside risks to the Brazilian currency. While it is true that the approval of the fiscal plan, currently scheduled for June, will provide some reassurance on the domestic front, we believe its impact will be more than offset by expectations of BCB easing in Q3 and sustained fears of China's slowdown, Brazil's main trading partner.

CE3

Hungary blinks first

The key driver for CE3 currencies in recent months has been monetary policy expectations. Up until April, the trend for CE3 central banks had been one of convergence, and with all three economies suffering from very high rates of inflation and policy on hold, the respective currencies followed suit. The NBH policy meeting on April 25th was the first sign that this narrative was beginning to shift, with the central bank delivering a symbolic easing in the policy stance. But it also hinted towards an easing of effective policy rates, a move that the NBH ultimately delivered on in May. The NBH cut the effective policy rate by 100bp, setting a path towards normalising its policy stance. Now the question for FX markets becomes just how fast this will take place, and how soon will the other CE3 countries follow in cutting rates.

In our view, a continued easing of policy in Hungary over the coming few months is now inevitable. We expect 100bp cuts to the effective rate at each of the next few meetings, at least until it can be aligned with the main policy rate. For now, the modest easing so far has led the EURHUF to marginally underperform our previous forecasts, although the recent retracement in the cross has marked an end of the general downtrend of recent months. Given the accumulation in long forint positioning on the back of carry trade demand, and with policy easing now well and truly in progress, a sell-off in the currency looks set to follow. As such, we are maintaining our structural view of EURHUF upside.

For Poland and the Czech Republic, the question is when not if the respective central banks pivot to cutting rates. Whilst the NBP has consistently produced the most dovish rhetoric of the two, this has also drifted modestly more hawkish in recent months, with the shift in tone supporting EURPLN down to current levels. But with inflation not just coming down but also undershooting expectations, and a surprise upside to Q1 GDP numbers, the balance of risks suggests that this move is now played out. Whilst more downside is possible if the NBP outperforms its dovish rhetoric and ultimately keeps rates higher for longer, political developments and in particular an upcoming presidential election raises the possibility of an early easing in monetary policy. As such, we think EURPLN is likely to continue trading in current ranges over the medium term, with risks skewed equally to both sides. The CNB in contrast has maintained a hawkish bias in their communications and has at times expressly signalled a willingness to intervene in FX markets in order to support the koruna. Somewhat softer than expected inflation data and stronger than anticipated growth have raised the prospect of the CNB pulling forward monetary easing, leading to EURCZK marginally outperforming our target in the past month, but is consistent with our view for modest koruna depreciation over the longer term, a view we continue to hold.

Forecasts

Currency Pair	1-month (30th June 2023)	3-month 31st August 2023)	6-month (30th November 2023)	12-month (31st May 2024)
G10				
EUR/USD	1.085	1.085	1.10	1.12
USD/JPY	138	130	125	125
GBP/USD	1.25	1.25	1.26	1.28
USD/CHF	0.90	0.90	0.91	0.91
USD/CAD	1.34	1.33	1.30	1.30
AUD/USD	0.67	0.67	0.68	0.69
NZD/USD	0.61	0.62	0.62	0.63
USD/SEK	10.9	11.0	10.5	9.8
USD/NOK	11.06	10.6	10.0	9.46
DXY	103	102.2	100.3	98.8
Emerging Markets				
USD/CNY	7.15	7.2	7.0	6.8
USD/INR	82	83	81	80
USD/SGD	1.34	1.35	1.33	1.33
USD/ZAR	20	20.5	20	18
USD/TRY	21.5	22.5	23	24
USD/PLN	4.19	4.19	4.09	3.97
USD/HUF	350	359	364	366
USD/CZK	21.7	21.7	21.8	21.9
USD/BRL	5.1	5.15	5.2	5.2
USD/MXN	17.5	17.8	18.2	18.6
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	1.00	1.02
EUR/CAD	1.45	1.44	1.43	1.46
EUR/SEK	11.8	12.0	11.6	11.0
EUR/NOK	12.0	11.5	11.0	10.6
EUR/TRY	23.3	24.4	25.3	26.9
EUR/PLN	4.55	4.55	4.5	4.45
EUR/HUF	380	390	400	410
EUR/CZK	23.5	23.5	24.0	24.5
EUR/BRL	5.5	5.6	5.7	5.8
EUR/MXN	19.0	19.3	20.0	20.8

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