MONEX

FX Forecasts

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AUTHORS

SIMON HARVEY
Head of FX Analysis
+44 (0) 203 650 6472
Simon.Harvey@monexeurope.com

JAY ZHAO-MURRAY
FX Market Analyst
+1 647-480-1812
Jay.Zhao-Murray@monexcanada.com

MARÍA MARCOS
FX Market Analyst
+34 911 988 460
Maria.Marcos@monexeurope.com

NICK REES
FX Market Analyst
+44 (0) 203 650 3736
Nicholas.Rees@monexeurope.com

CONTENTS

02
INTRODUCTION
05
FX VIEWS
05
US dollar
Most routes point higher
05
Euro
Parity is in scope on recession
05
Swiss franc
Still a eurozone hedge despite SNB hold
06
Japanese yen
On watch
06
Chinese yuan
Risk of increased tolerance to USDCNY upside
06
British pound
Hiking over, but with growing concerns
07
Canadian dollar
Foiled on the final day
08
Scandis
Still too early to turn constructive on SEK
09
Central European Three
Waning confidence
10
Latin America
Carry still in favour but risks are building
11
FORECASTS

INTRODUCTION

Nearly all paths lead higher for the dollar

In September we pushed back our expectation for the structural dollar decline beyond 24Q1 while simultaneously uprating our near-term view on the expectation that the US economy would remain in a much more resilient position than its peers, leading the dollar to post moderate gains on widening growth and rate differentials as the data supported the Fed's more credible "higher for longer" guidance. Despite envisaging further upside in the broad dollar, we thought this would be limited by front-end Treasury yields, where we saw very little room for a continuation in the rally.

This, however, was a miscalculation on our part. Firstly, front-end yields continued to rally over the month as the Fed's projections for 2024 and 2025 were slightly more hawkish than our baseline while oil prices continued to rally on widening supply deficits, adding further credibility to the Fed's hawkish messaging. Over the course of the month, yields on the 2-year rose by 18bps, while they hit a fresh post-2006 peak of 5.197% mid-month. Secondly, and arguably more surprising, was the duration sell-off in core bond markets and the impact that had on the dollar through the risk channel. Here, the sharpest bear steepening in the US yield curve (28bps) since the rollout of Covid vaccines in 21Q1 began to weigh on equity valuations, especially in growth sensitive industries. While the pain in equities was most pronounced in US capital markets, which have outperformed year-to-date, the influence this had on overall risk conditions outweighed any impact it may have had on portfolio reallocations. In FX markets, this saw the left-hand side of the dollar smile channel re-open for the first time this year. This in combination with a more hawkish Fed and rising recession concerns meant market conditions over the course of September were reminiscent of late-2022.

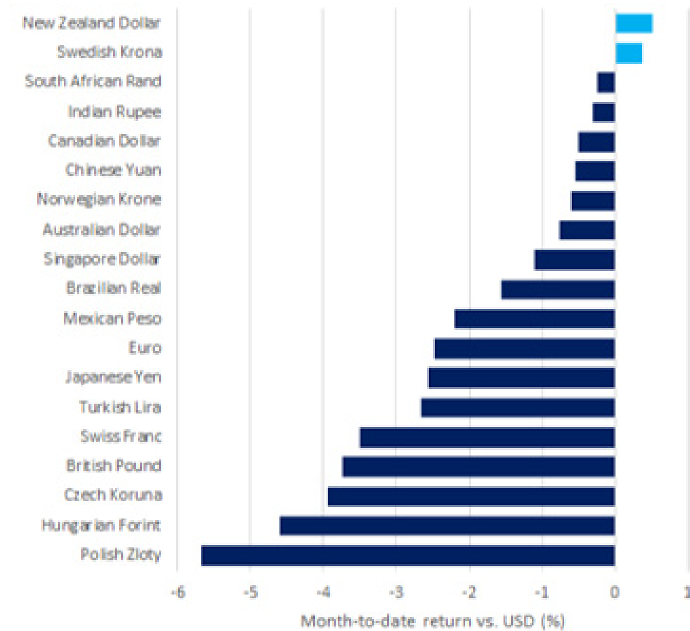
While the rally in the DXY index exceeded our expectations, events over the past month further confirm our view that downside in the dollar is unlikely to take place until Q2 2024 at the earliest, when the Fed's easing cycle begins to come back into view for FX markets. They also highlight a broadening in the scope of risks for markets, with uncertainty no longer pertaining to just the incoming economic data, a development likely to support the dollar over the course of Q4. While there remains a path lower for the dollar, based on improving growth conditions in the eurozone and China alongside a moderate slowdown in US growth, we think this path has narrowed, largely because weaker US economic data in this more risk sensitive environment poses the risk of a further haven USD bid. Therefore, while we maintain our view that the dollar is likely to depreciate over the longer-term, broadening USD supportive dynamics have led us to revise up our near-term forecasts for a second consecutive month.

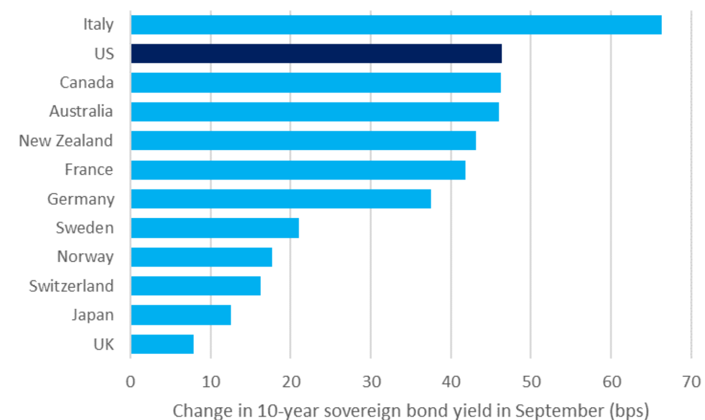
Dollar DXY index outperforms our forecasts for a second consecutive month in Q3, leading us to revise up our Q4 forecasts

The dollar had multiple channels to climb higher

Fresh highs in oil and the broad sell-off in duration, led by US Treasuries, meant the dollar rally was largely unimpaired over the course of September as it benefitted from widening growth and rate differentials, given the US economy is more insulated from the stagflationary effects of higher oil, and haven inflows on the deteriorating risk environment.

The dollar broadly rallied against the expanded majors as back-end Treasuries led the sell-off in duration





Currencies that experienced the most pronounced sell-offs against the dollar did so because they were hit by all three factors: a widening in growth differentials due to the oil rally having a negative effect on their terms-of-trade, widening rate differentials due to dovish policy surprises relative to the hawkish Fed messaging, and a high beta to global risk. This was generally the case for CE3 currencies, which filled three of the four bottom spots in the monthly FX rankings. Although all three economies are major oil importers and their respective currencies exhibiting a high beta to global risk, it was actually the actions of the National Bank of Poland that can explain the bulk of the underperformance given the impact in had on sentiment in the region. Cutting rates by 75bps, the NBP decision seemed more politically motivated than driven by the economic fundamentals and as such led to a sharp sell-off in the Polish zloty. However, this also had broader reaching implications as it sparked concern that similar actions would be taken by peer central banks later in the month, especially given growth conditions remained depressed in the region. While policymakers across all three central banks tried to alleviate these concerns, culminating in both the National Bank of Hungary and Czech National Bank holding policy and relaying hawkish guidance at the end of the month, the damage was seemingly already done, leading to a more pronounced sell-off in CE3 FX than we had forecast.

> "At the other end of the spectrum, Asian currencies generally outperformed on crosses, with the average return of -1.0% exceeding the median return for all expanded majors."

For most major EM currencies, actions by their central banks limited further losses against the greenback, with INR and CNY in particular standing out, depreciating by just -0.3% and -0.5% respectively despite a widening in yield spreads and a deterioration in their terms-of-trade. At the other end of the spectrum, the South Korean won notably lagged behind its Asian peers, falling by -2.0% as the export-driven economy shipped the fewest goods abroad in almost two years. Korean authorities have tried to push back, with recent filings showing they sold nearly $6bn in USD over the course of Q2, and continuing to voice support for the currency should the bleeding persist.

Within the G10, where the distribution of returns was notably narrower, three notable trends emerged. First, the Swiss franc and Japanese yen—the two currencies aside from the US dollar which are viewed as safe havens—failed to show their haven properties despite a deterioration in global equities. The franc fell by -3.5% against the dollar, while the yen fell by -2.6%. The SNB and BoJ are subject to blame, considering both central banks struck a dovish tone over the course of the month. However, with USDJPY trading close to levels where the BoJ previously conducted "stealth intervention" and with CHF depreciating at a time when credit concerns are rising in Europe, we think this trend is unlikely to persist in Q4. Second, growth concerns have become especially prevalent in Western Europe, with deteriorating PMIs in the eurozone and UK

suggesting that recessions may be looming on the horizon. Both the euro (-2.5%) and pound (-3.7%) suffered hefty losses as a result, with the Bank of England's decision to hold policy rates steady contributing to the latter's weaker performance. Third, commodity currencies outperformed the rest of the G10 basket. Taken together, the average return across CAD (-0.5%), NOK (-0.6%), AUD (-0.8%), and NZD (+0.5%) was -0.3% in September, considerably better than the -1.5% average return for all G10s. Traders can thank crude oil for that, where tight supply led the commodity to break out to its highest levels for 2023.

Out of all the currency groupings, however, Latin America showed the greatest degree of variability. The average return for LatAm was -1.7%, worse than average for all expanded majors, but the range was extremely wide.

> "The Colombian peso continued to notch gains given its elevated level of carry and role as an oil exporter, while the Brazilian real was somewhat bogged down by the BCB's decision to keep easing policy and signs that China's property sector remains under pressure."

Out of all the LatAm currencies we track, the notable standout was the Mexican peso, where losses occurred despite a continued widening in yield spreads amid delayed expectations of Banxico easing and limited signs of a growth slowdown. In our view, the decline in MXN largely represents the deterioration in risk conditions from the sharp sell-off in Treasuries and the impact that had on one of the most popular carry positions of the year, not necessarily a shift in the currency's fundamentals. As a result, this provides a good entry point to re-engage in long MXN positions, albeit with greater associated risks than in the first half of the year.

Duration may have further to sell-off

One of the most surprising developments in September was the sell-off in duration. While partially explained by the "higher for longer" narratives spouted by most central banks and the rally in oil, there were also more structural factors at play. These included, but weren't limited to deteriorating fiscal trajectories, quantitative tightening, less recycling of dollars from China, a reduction in the global savings glut, not to mention a positioning flush out. With most prominent oil analysts suggesting the rally in oil will begin to slow from here and most major central banks not set to announce their next policy decisions until November, with only a few set to tighten policy further under our base case, it is reasonable to assume that the sell-off in duration is likely to slow, or even reverse, in the coming month. However, this is unlikely to reverse the course in USD price action as the tightening in financial conditions that has already taken place is likely to have a greater impact on eurozone growth conditions and continue to weigh on global equities, leading the dollar to remain the beneficiary of a haven bid.

The broadening scope of macro risks also supports defensive USD positioning

The past month hasn't just seen the risk environment deteriorate, but also the scope of risks expand. Whereas in Q3 most of the macro risks pertained to the evolution of economic data, they now include fiscal challenges (US shutdown, EU 2024 budgets), monetary easing in some early hikers, FX intervention risk, and a crunch time in China's growth outlook. With CFTC positioning only just turning slightly dollar bullish in the past weeks, we think there remains scope for a build-up in defensive dollar positions as the pool of risks expands.

Non-commercial net long positioning in the dollar is substantially below levels normally associated with the current amount of macro risks

FX VIEWS

DXY

Most routes point higher

Developments over the past month have highlighted that the dollar is no longer supported by just a widening in rate and growth differentials, a.k.a the US exceptionalism narrative, but also the broadening of macro risks. With the dollar now subject to more channels of appreciation and with haven flows likely to remain supportive heading into a pivotal period in Q4 for growth expectations, we have revised up our 3-month forecast and now project the dollar to close the year out higher, despite our long-held view of mild dollar depreciation throughout 2023. Risks around this view are plentiful and largely skew in favour of the dollar outperforming our 1-month and 3-month forecasts once again. While the domain of upside risks is broad, a more pronounced recession in eurozone growth in 2H23 and a greater tolerance for currency depreciation by Asian policy officials present the two largest and most significant upside risks (see EUR, CNY, and JPY).

While there remains a path lower for the dollar into year-end, contingent on data showing the eurozone growth downturn has bottomed out and that China's economy has begun to reaccelerate at a time when US growth slows, we believe this path has narrowed and is fraught with risk. One of the primary risks remains the US growth outlook, which has proven more resilient than most analysts had anticipated year-to-date. While data shows the American excess savings glut has now been spent, there remains a risk that the US economy continues to produce steady and robust growth. Even under a slowdown in growth, which should see the Fed skip on their projected Q4 rate hike as per our base case, there remains a risk that markets interpret the softer US data in a more sinister manner given growth concerns elsewhere. This should see a continued sell-off in global equities coincide with limited downside in front-end Treasury yields. With very few haven assets remaining, this would likely see further dollar appreciation.

EUR

Parity is in scope on recession

The single currency fell 3.2% against the dollar to trade at the lower end of its 2023 range and close out the month two points below our forecast of 1.07. While we didn't rule out such an outcome in our September forecasts, we noted that a decline to this year's lows required a material increase in the risk of a eurozone recession this year. With the details of the latest eurozone PMIs painting a much bleaker outlook for Q4 than the headline figures suggest, the recent rally in oil prices providing another stagflationary impulse for the eurozone economy to contend with, and financial conditions tightening considerably, we now think a recession in the eurozone in 23H2 is more likely than not. This reality is now fairly priced into spot EURUSD, in our view.

Looking ahead, however, we think it remains too soon to turn constructive on the single currency. Despite a recent improvement in inflation data, we think the ECB will continue to push back on any premature pricing of rate cuts, meaning sovereign financing costs are likely to remain high at a time when growth conditions are weak. Some eurozone bonds have already started to reflect this, with the BTP-Bund spread notably widening to 200bps towards the end of last month. In our view, there remains considerable scope for spreads to widen further beyond this point. Recent history suggests this tends to be a negative outcome for EURUSD, even with the ECB's new TPI. Furthermore, despite green shoots appearing in the Chinese data, these are yet to blossom into a more optimistic export outlook for the eurozone, with new export orders remaining depressed. The combination of tighter credit conditions, fiscal limitations, and a still weak external growth outlook suggests there remains room for EURUSD to plumb lower in the coming months, before a bottom starts to become clear in the macro data.

While we now expect EURUSD to reach 1.03 by year-end, we think either energy or bond market conditions need to deteriorate further for another test of parity. Under our base case for commodities—that the rally in oil benchmarks is likely to slow from here and there remains little signs that European natural gas markets will replicate last year's price action—we think fiscal dynamics pose the biggest risk of EURUSD returning below parity for the first time since November 2022. Here, we think eurozone bond spreads have the capacity to widen further, but the reimposition of the European Commission's fiscal rules and the increased risk premium in bunds should prevent the BTP-Bund spread from reaching 250bps, an outcome we think necessary for EURUSD to drop below parity.

CHF

Still a eurozone hedge despite SNB hold

Whilst we spent much of the past few months off consensus in our call for the SNB's September meeting where we looked for rates to be held at 1.75%, this view was ultimately vindicated, with it now appearing that the SNB is finished with its hiking cycle. Given this, attention for policymakers and markets now turns towards FX tools, used by the SNB to manage imported inflation pressures. Granted, CHF notably sold off following the surprise rate hold on the 21st, but we suspect expect the SNB is unwilling to see the franc continue depreciate given the inflation risks. Under our expectation of a eurozone recession and EURUSD plumbing to 1.03 in one-months' time, coupled with the SNB's appetite for a stronger franc to buffer imported inflation risks amid a more inflationary external environment, we have downgraded our one-month EURCHF call to 0.95. Risks to this call are two-sided. While a more pronounced recession in the eurozone and further ruptures in eurozone bond markets pose downside risks, we think this will be offset by the SNB given the deflation threat this poses. Meanwhile, upside in EURCHF is likely to be limited, not only by the SNB's actions given their expectation headline inflation will return back above target, but also the still tentative risk conditions in the euro area.

JPY

On watch

Despite speculation that the Bank of Japan was warming to the idea of tightening monetary policy following Governor Ueda's interview with the Yomiuri newspaper early in September, the central bank was quick to dampen expectations that another adjustment in the yield curve framework would be likely this year. Against a backdrop of higher Treasury yields, continued downward pressure on CNY, and more expensive oil, the Bank of Japan's dovishness led the yen to depreciate towards the 150 handle, in line with our 3-month forecast.

With markets fully aware that the BoJ last committed "stealth intervention" at these levels in October 2022, the act of which led to a sudden and unannounced 2% rally in the yen, there is a hesitancy to take the USDJPY pair through the 150 handle. While some sell-side analysts state that stealth intervention is less likely this time around given the yen scans as stronger on a trade-weighted basis and the BoJ is more concerned by the pace of depreciation, we think there is a premium to the BoJ topping up the psychological impact of its previous measures at this level. While we can't discount a further appreciation in USDJPY in Q4, we think the credible risk of renewed intervention and policy tightening from the BoJ heading into 2024 should limit further upside in the pair. On the contrary, downside risks are likely to induce a more substantial, albeit varied, market reaction. In terms of stealth intervention, we expect this to have a significant yet short-lived impact on markets as it fails to address to root cause of depreciation. Conversely, monetary tightening from the BoJ would have the most sustainable impact, although we think this is likely to be a story for 2024. Reflecting this, we now envisage USDJPY trading at 150 for the remainder of the year, noting risks remain two-sided but skewed to the downside.

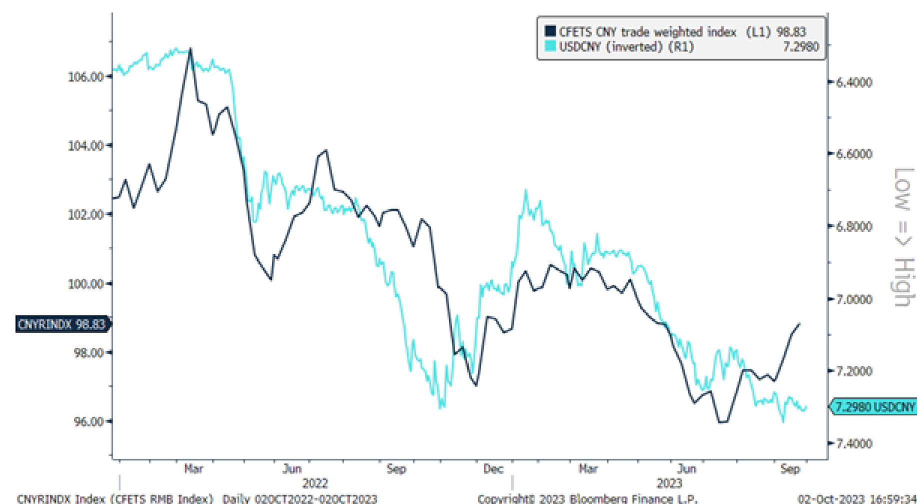
CNY

Risk of increased tolerance to USDCNY upside

The past month has been characterised by relative stability in the USDCNY rate, with improving economic data and the PBoC's intervention efforts offsetting the impact of renewed housing concerns and higher Treasury yields. While we remain confident that the PBoC has the firepower to offset any further upside in USDCNY beyond 7.30, we are now more dubious about their preference to do so, especially after the central bank recently signalled their focus remains on the trade weighted index as opposed to the USDCNY rate per se. Here, the relative stability in USDCNY amidst a stronger dollar environment has resulted in the CFETS renminbi basket appreciating close to 2% on the month.

While we think continued appreciation or even stability in the trade-weighted yuan raises the risk that the PBoC relaxes its defence of the 7.30 handle on USDCNY, we note that the risk is limited over the one-month horizon, especially as further appreciation in USDCNY poses the risk of eroding consumer confidence at a time when the recovery in consumption remains nascent. However, we cannot discount this risk over the course of the fourth quarter. Given CNY's recent stability has been a limiting factor in the dollar rally, any decision to allow USDCNY to drift above 7.3 on a managed basis will likely result in another bout of broad USD strength.

Stability in USDCNY sees the yuan rally close to 2% on a trade weighted basis in September

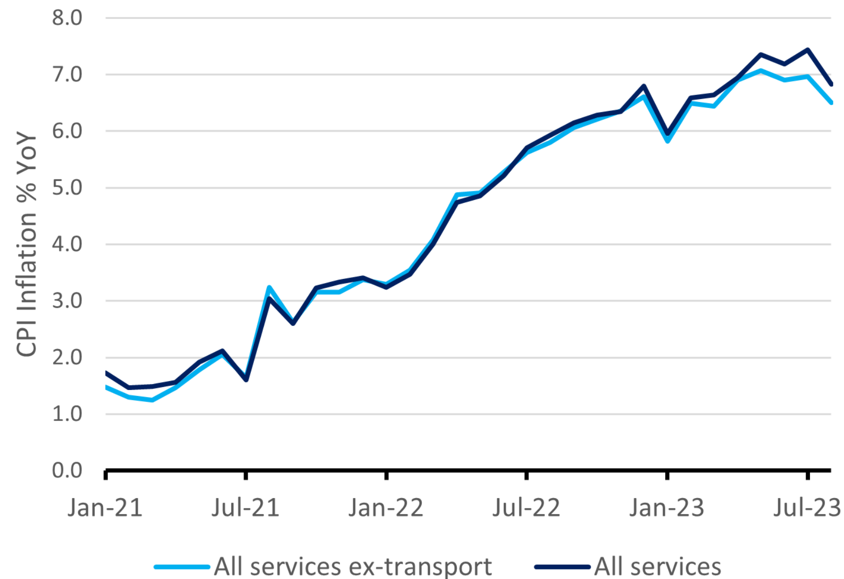


GBP

Hiking over, but with growing concerns

In our last set of forecasts, we had expected sterling to trade broadly sideways against the dollar, though with significant risks to either side of this view. Fundamentally, this was underpinned by the idea that markets would continue trimming Bank Rate expectations, weighing on sterling, before inflation and growth data alongside a final BoE hike put the UK's relatively decent investment outlook front and centre. This view had appeared to be playing out, at least until the Bank of England delivered its latest policy decision on September 21st, where policymakers surprised markets by keeping rates on hold, despite strong pre-release consensus looking for a hike. Initially it appeared that this decision was prompted by a single soft CPI release coming the day earlier. But reflecting on the meeting minutes, it appears that the BoE also had access to at least some of the September PMI numbers before they made their final decisions. With the BoE holding rates and growth data showing a more benign outlook, UK rates fell more than we expected, leading to a more pronounced sell-off in the pound.

Services inflation showed signs of falling in the August CPI release, though this was less pronounced once stripping out transport costs



Taking these developments in the context of recent dovish commentary by BoE Governor Andrew Bailey, and comments by Huw Pill indicating his preference for a "Table Mountain" profile for Bank Rate, we are updating our call for BoE policy tightening. In our view, the BoE will not hike in November, and we now expect Bank Rate to be held at 5.25%, until at least H2 2024. Admittedly, though, risks to this view remain skewed to the upside in the near-term. Looking at the two key factors that appear to have tipped the balance for the BoE, CPI data and PMIs, we see risks for the next round of releases as skewed to the upside. The September PMIs may well have been artificially depressed by seasonal adjustments, meaning that they may well be revised upwards early this month. Moreover, with a less significant seasonal adjustment typically applied to the October PMIs, then barring a marked slowdown in the underlying figures, the next round of PMIs are likely to show an improved picture. In terms of CPI numbers, these slowed more than expected, and in a welcome development much of this was driven by slowing price growth in components sensitive to consumer discretionary spending, suggestive that BoE hiking is working. Nevertheless, a significant contributor to the expectations undershoot was driven by the seasonally volatile transport component. Therefore, given the BoEs recent tendency to react strongly in response to the most recent round of data prints, we cannot rule out a further rate hike being delivered in November just yet given the possibility of a rebound in the September CPI print.

In addition to the monetary policy outlook, we have also lowered our conviction in the strength of the UKs growth, and therefore investment outlook, in light of two recent developments. First is the slowdown in PMI numbers discussed above. Second, though, are prospective government actions. The UK is only a year removed from the Truss and Kwarteng mini-budget which sent Gilt yields spiralling and weighed heavily on the pound. Given these events, government spending plans are under more scrutiny in the UK than many other developed economies, as is the government's credibility on balancing the books. As such, inactivity in fiscal policy is likely to weigh on UK investment relative to other economies where fiscal authorities are taking a more active role in stimulating potential growth and green transitions. For sterling, the lower outlook for peak Bank Rate and weaker growth outlook translates into some downside in the short term. Indeed, we have already seen this play out in markets with sterling significantly undershooting our one month forecast. However, we still think the underlying thesis for the UK economy will play out, with the BoE holding rates at the current level longer than markets currently expect, an improving real rates profile and UK growth looking decent compared with many eurozone economies. Given this, we continue to expect a sterling recovery over the longer term, but adjust our projections downwards in the near-term to reflect to the weaker starting point for the pound.

CAD

Foiled on the final day

In our September forecasts, we argued that the loonie's sell-off over the course of August was overdone, with the currency disconnected from its fundamentals and subject to retracement. This didn't immediately pan out, as on the first day of September, GDP data for Q2 came in shockingly weak relative to expectations, posting a -0.2% annualised contraction. The loonie sold off sharply that day, and downside momentum persisted over the next week as traders downgraded their monetary policy expectations, while the Bank of Canada held interest rates steady at 5% and appeared less than keen to hike further.

This led the Canadian currency to briefly touch a six-month low against the US dollar, but a stronger-than-expected jobs number and further crude oil production cuts from Saudi Arabia turned its fortunes around. As the oil rally picked up pace, so did the loonie's bullish momentum, which persisted for a week and a half to bring USDCAD close to our 1-month forecast of 1.3450. A surprise increase in core inflation countered the message of the soft growth data, and the knee-jerk reaction even led USDCAD to break below 1.34 and temporarily hit highs not seen since early August. At this point, downside in USDCAD fizzled out, leading the pair to trade around our forecast of 1.3450 for the remainder of the month, that is until the last day of Q3. However, in a cruel twist of fate the final trading session of the month echoed the first, with another soft GDP print triggering a sell-off in CAD. This saw the currency pair rally 0.7%

on the day as BoC expectations were trimmed once again while risk assets were also under pressure. All in all, we were left with a 1% forecast error, with the bulk of it explained by the price action in the final hours of the last session of the month.

"Looking ahead, our short-term cross-asset models no longer suggest that USDCAD is overbought, even though the loonie remains undervalued based on long-term fundamentals."

The data released over September has not changed our view on the Bank of Canada—we continue to expect no further hikes—but now that the economy looks more stagflationary, the risk of another resumption to the hiking cycle is elevated. Should the BoC opt to hike once again, October's meeting presents the best opportunity to do so seeing as it comes with a fresh MPR. However, such actions would only be CAD positive if confirmed by resilient growth data. The opposite is also true in our view. With the most recent GDP figures having led markets to re-evaluate the Canadian economy's growth prospects down from solid to stagnant-at-best, we do not think a hold from the BoC would weigh much on the loonie. Furthermore, we think crude oil has sufficiently repriced to account for the most recent supply cut news, and barring further supply announcements from OPEC+ members, we expect benchmarks to consolidate near recent highs. With both interest rates and oil expected to hold steady, near-term performance in USDCAD will likely be driven by global risk sentiment and US equity performance, especially since CAD has the highest correlation with the S&P 500 out of any G10 currency. Here, the balance of risks is largely two-sided. To the upside, continued resilience from the US consumer, reduced pressure from back-end bonds, and positive seasonal flows should lead to a stronger month for equities. Meanwhile, the resumption of student loan repayments and resurgence of inflation pressures pose downside risks. Overall, we maintain a neutral view on equities, but note their performance are likely to be the dominant catalyst for CAD price action, especially given the elevated level of risks around Q3's earnings.

Scandi FX

Still too early to turn constructive on SEK

Both Scandi central banks raised rates in September by 25 basis points, though the announcements were interpreted rather differently by markets. The Riksbank was once again seen as being overly dovish, placing more downwards pressure on the Swedish krona, whilst in contrast the Norges Bank appeared rather hawkish, helping support continued NOK outperformance. That being said, a turnaround in SEK towards month end could well mark the beginning of a more sustained recovery for the Swedish currency, although we think it is currently premature to hold this view with any conviction.

Looking at Sweden in more detail, the Riksbank has one more monetary policy meeting this year, with a decision due to be announced on November 23rd. Swedish policymakers have indicated a 40% chance of a further rate hike in their most recent economic projections, though we think given the risks posed by a fragile krona recovery, a final rate hike to defend SEK strength looks more likely than not at this point. Indeed, having signalled to markets the importance of krona strength as an inflation fighting tool in June, suggesting the possibility of hedging their FX reserves and in effect declaring a bottom to SEK weakness, the September policy meeting saw policymakers follow through on this promise. In our view, the USD8bn and EUR2bn that the Bank intends to hedge over 4-6 month is unlikely to significantly weigh on the exchange rate directly: assuming hedging is evenly spread over that period, it would account for less than 1% of total daily volumes. That said, the krona notably picked up towards month-end nonetheless. This, however, was more likely a response to news that SBB, a large Swedish landlord, had managed to secure a financial lifeline through a deal with private equity firm Brookfield, alleviating some concerns around the stability of the Swedish housing market and boosting broader market sentiment. However, this sentiment improvement for Sweden is unlikely to be sustained. Instead, we remain vigilant of an improvement in growth conditions in the continent or the overall risk environment before we can turn more constructive on SEK.

The Norwegian krone by comparison has had a slightly quieter time recently, with EURNOK performing largely as expected to end the month almost exactly at our target of 11.3, though not entirely for the reasons we predicted. In particular, the recent rally in oil has seen the krone pick up some unexpected support short term, though ultimately this should be offset by an increase in FX purchases over coming months. The most important question moving forwards is whether or not the Norge's Bank will hike again this tightening cycle. On the one hand, indications by Governor Ida Wolden Bache were clear, a further hike is likely, most probably in December. On the other, some analysts have suggested that further tightening could be unnecessary at this point. In our view, given the central banks recent track record of following through on these policy pronouncements, we are inclined to take the Governor at her word. Therefore, we expect the Norges Bank to "skip" the November meeting before delivering a final rate hike in December. This should keep NOK on its current upwards trend, though with no meeting due in October, the impetus should be modest. Oil prices too should continue to be a supportive factor for the krone. Rallying strongly into month end, they should continue to strengthen through Q4 if OPEC+ members continue to restrict supply as promised. Given this, we are broadly holding our prior EURNOK call, though updating our 1m forecast to reflect the fact this has already been met.

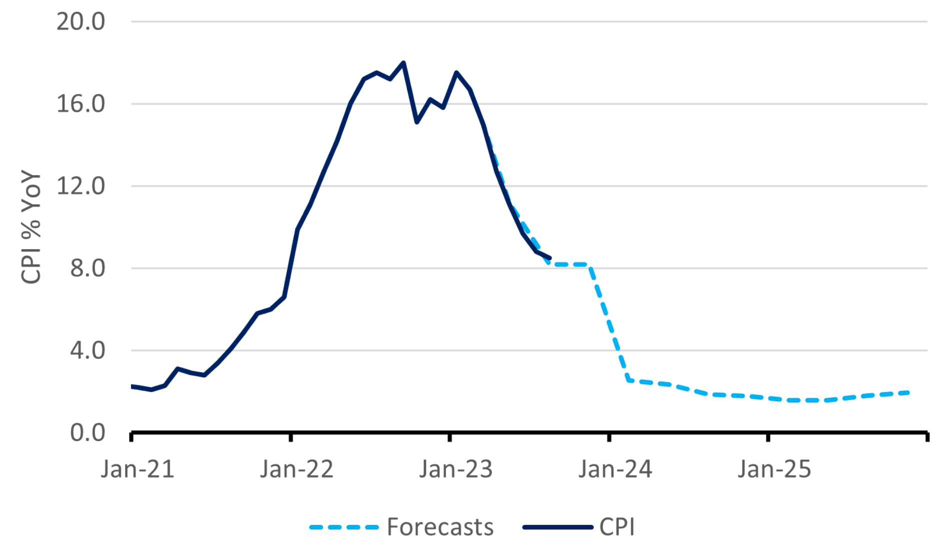
CE3

Waning confidence

The NBP sent shockwaves through CE3 FX markets in September, surprising with an unexpected 75bp cut in the policy rate, bringing it to just 6%. Whilst some MPC members had signalled that a rate cut might be coming, a risk that we flagged in our September forecasts, statements by Governor Glapinski that easing would be done in small steps once inflation was below 10%, meant that both the size and timing of this month's decision blindsided markets. Accordingly, the decision was widely interpreted as politically motivated given the upcoming Polish general election and the perceived closeness between a number of MPC members and the ruling Law and Justice party. Admittedly, headline CPI now shows inflation well below Glapinski's threshold, coming in at 8.2% on September 29th. Even so, the decision was still not justified by economic fundamentals in the eyes of most analysts, and we agree. In this light, the zloty saw a sell-off, as weakened economic fundamentals and eroded central bank credibility weighed on the Polish currency. Coming up this month, it is hard to predict if the NBP will cut rates further with them previously having ripped up their reaction function. We see risks as marginally tilted towards a further 25bp easing, likely spurring another bout of zloty weakness, but hold this view with very low conviction. The election on October 15th is also likely to be key, with the ruling Law and Justice party likely to secure the most votes according to current opinion polling, but ultimately fall short of securing a parliamentary majority and setting the stage for political ructions that could also weigh on the Polish currency. All together, this likely set the scene for further, faster zloty depreciation than we previously anticipated and we update our call for EURPLN accordingly.

The NBH in contrast followed through on normalising their policy stance, aligning their effective emergency interest rate with the base rate, and readjusting their interest rate band to lie +/- 100bp around this point. Looking forwards, given the lack of guidance on further policy easing and the good track record in telegraphing such moves, we expect that October will be used to pause and take stock of data developments. That being said, with policy rates at 13.00%, inflation due to fall to 7-8% by year end and an economy in recession, we think a resumption in rate cuts from November onwards will be necessary to prevent real rates from turning sharply positive and support growth conditions. Given this view, we expect that the forint should hold up over the next month or so as carry erosion takes a pause. But a resumption in rate cuts towards the end of the year and into 2024 should ultimately end up taking the forint lower over the longer term.

Inflation cooling in the Czech Republic is set to temporarily stall, before starting up again in early 2024



The CNB too failed to surprise in September, though this was perhaps the most predictable of the three meetings. Indeed, reading the policy statement, it appeared the Bank Board had taken note of the NBPs decision. In contrast to their Polish equivalents, however, the CNB opted to keep rates on hold and give little away on the likely policy actions at future meetings. Given the Banks expressed data dependency, and with progress on disinflation set to stall temporarily in coming months, we suspect they will wait until 2024 until beginning the process of cutting rates. Even so, CZK has found itself dragged lower as the effects of the Polish decision spilt over into broader CE3 price action. The hawkish tone of the CNB board through the month, however, was sufficient to keep any sell off contained. With the koruna set to end the month modestly above our price target, we are upgrading short term projections for EURCZK. Further out though we expect a modest weakening trend for the koruna to shine though, as monetary policy easing erodes the korunas favourable carry, in line with our previous forecasts.

LatAm

Carry still in favour but risks are building

The risk-off move in global markets, driven by rising US yields and oil benchmarks alongside intensifying stagflation dynamics outside the United States, coupled with region-specific drivers to weigh on LatAm FX late in Q3 earlier than we had expected. In Mexico and Brazil, cooling inflation conditions have forced traders to now confront the prospect of monetary easing and the risk that poses to the long-LatAm carry trade, a strategy that has notably outperformed in a year that has seen few lasting market trends and waves of USD appreciation. While at first glance the erosion of the carry trade profile in Latin America should weigh on the respective currencies, for now we have seen fairly stable responses in the spot markets, even as the Federal Reserve continues to advocate "higher for longer", meaning that inflation-adjusted interest rates remain highly attractive.

"Although most Latin American currencies have withstood the stronger dollar environment, the situation is not homogeneous, and we expect this to remain the case."

In the case of the Mexican peso, this can be partly explained by idiosyncratic factors, such as Banxico's decision to phase out its currency hedging programme and saturate long positioning. While net long non-commercial positions in MXN futures have been steadily declining since June, it still remains historically high, leaving MXN subject to sharp sell-offs, as exhibited in the 5% drop in the day's after Banxico's decision to reduce its hedging programme. This dynamic also partly explains why the peso's depreciation outstripped the Brazilian real's in September as global risk conditions deteriorated. Despite the sell-off in MXN, the evolution of domestic fundamentals in Mexico continues to be positive, which we see as providing further support to the currency. The latest monthly indicator of economic activity, published by the IGAE, still points to a solid expansion profile in Mexico, even though growth is reported to have slowed in July to 3.19% on an annual basis and was just 0.15% month-on-month. But, according to the latest economists' surveys, this slowdown is unlikely to be continued through the third and fourth quarter GDP readings, with consensus expectations looking for 2.8% and 2.2% growth in Q3 and Q4 respectively, revised upwards from 2.6% and 1.9% anticipated previously. Moreover, positive news for the peso is not just limited to growth. Indeed, given the outcome of the Fed's last rate decision and especially its upwards revision of the median dot for 2024 and 2025, we believed Banxico would follow suit, pushing back expectations of easing into 2024. This materialised, with the Bank's decision to leave the benchmark interest rate unchanged at 11.25% setting a tone that was understood by markets as markedly hawkish than the August meeting. This message was reinforced by an update to the banks inflation projections to show a higher rate of price growth over the entire forecast horizon, one which pushes out convergence to the Banks 3% target from 2024 Q4 to 2025 Q2.

The forecast updates are illuminating about the monetary authority's intentions going forward in our view, adding credibility to the Banks higher for longer narrative. Therefore, we maintain our view that high rates will keep the peso carry trade alive over coming months. Whilst there is a risk that signs of premature easing or a continued deterioration in risk conditions could push USDMXN to rally back above the 18.00 handle for the first time since Q2 as long MXN positioning unwinds further, our high for longer base case should see a USDMXN range of 17.3 – 17.5 range in Q4.

In the case of BRL, the story is very different. In theory, the BCB's decision to initiate a monetary policy easing cycle should have weighed on the Brazilian currency, especially in an environment where the Fed continues to target another rate hike this year. However, this has not necessarily happened, partly because the BCB's easing cycle appears more moderate than initially feared and has relaxed tensions between the central bank and the executive, a major inhibitor for investor sentiment, but also because external conditions have improved for the currency. While we expect the BCB to continue cutting rates at a pace of 50 basis points per meeting this year, this should already be priced into currency markets and, as such, will not come as a surprise. Meanwhile, with green shoots appearing in China's manufacturing data and OPEC+ supply cuts keeping oil above $90 per barrel, demand for the real should increase along with the country's improving current account balance. All considered, this should see BRL continue to outperform on a spot basis, even as higher US Treasury yields and recession concerns in other developed market economies support a broad-based rally in the dollar. However, our bullish BRL view doesn't come without risks. First, we can't ignore the risk that the Lula administration reignites pressure on the BCB to ease policy more aggressively should domestic growth conditions begin to falter or the uptick in inflation continue to undershoot the BCB's projections. Secondly, there remains a chance that recent improvements in the Chinese data prove to be a red herring, especially after the latest round of property market worries. That aside, if conditions to develop as we expect, this should keep the real in the 4.8-4.9 range in Q4 as investors continue to favour exposure to high levels of carry, but we note risks are tilted towards a weaker BRL in the fourth quarter.

Forecasts

Currency Pair	1-month (31st October 2023)	3-month (31st December 2023)	6-month (31st March 2024)	12-month (30th September 2024)
G10				
EUR/USD	1.03	1.05	1.08	1.14
USD/JPY	150	150	140	130
GBP/USD	1.20	1.22	1.24	1.28
USD/CHF	0.92	0.91	0.91	0.86
USD/CAD	1.35	1.33	1.30	1.28
AUD/USD	0.655	0.665	0.680	0.680
NZD/USD	0.60	0.60	0.63	0.65
USD/SEK	11.4	11.0	10.4	9.6
USD/NOK	10.9	10.5	9.9	9.2
DXY	108.2	106.5	103.9	97.9
Emerging Markets				
USD/CNY	7.3	7.3	7.0	6.8
USD/INR	83.4	83.4	80	80
USD/SGD	1.38	1.38	1.37	1.35
USD/ZAR	19.5	19.0	18.0	17.0
USD/TRY	28	30	30	28
USD/PLN	4.6	4.6	4.4	4.1
USD/HUF	383	381	352	316
USD/CZK	23.7	23.4	23.1	21.5
USD/BRL	4.9	4.9	5.0	5.2
USD/MXN	17.4	17.4	17.2	17.0
Euro Crosses				
EUR/GBP	0.86	0.86	0.87	0.89
GBP/EUR	1.16	1.16	1.15	1.12
EUR/CHF	0.95	0.96	0.98	0.98
EUR/CAD	1.39	1.40	1.40	1.46
EUR/SEK	11.7	11.5	11.2	11.0
EUR/NOK	11.2	11.0	10.7	10.5
EUR/TRY	28.8	31.5	32.4	32.0
EUR/PLN	4.7	4.8	4.75	4.7
EUR/HUF	395	400	380	360
EUR/CZK	24.4	24.6	25.0	24.5
EUR/BRL	5.05	5.15	5.40	5.90
EUR/MXN	17.9	18.3	18.6	19.4

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