Economics and FICC Strategy

MONTHLY FX OUTLOOK

November 10, 2021

USD still the king of currencies

Currency	What's changed
USD	With the Fed's QE tapering expected to end in mid-2022, rate hikes will quickly commence, and markets should start to price in more from the Fed post-2022, helping the dollar to maintain its dominance.
CAD	Markets have overpriced BoC action in 2022, and underestimated the Fed post-2022. A recalibration will leave the CAD out of favor with investors.
EUR	Euro depreciation is expected ahead as the Fed outguns the ECB on both tapering bond purchases and raising rates.
GBP	Softer consumption backdrop amid the April tax hike to weigh on Sterling, compounded by trade friction risks with the EU.
JPY	With no end in sight to easy BoJ monetary policy, and yield curve control extended, look for yen weakness ahead.
Commodity FX	Monetary policy normalisation and the promise of more to come should support gains in NZD and AUD in 2022.
LATAM FX	An aggressive tightening cycle has begun in the region; Mexico should remain the outlier by hiking rates at a pace of 25bps in this year's remaining meetings.
FX Asia	PBoC maintaining pro-active monetary policy through managing liquidity conditions and demand for Chinese bonds, supporting CNY and CNH outperformance.

Currency outlook

End of period:	Nov 10/21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q2 23	Q4 23
USD / CAD	1.24	1.24	1.28	1.29	1.30	1.30	1.31	1.32
EUR / USD	1.15	1.14	1.13	1.11	1.10	1.10	1.12	1.15
USD / JPY	114	114	115	116	115	114	112	110
GBP / USD	1.35	1.33	1.33	1.31	1.31	1.32	1.34	1.36
USD / CHF	0.92	0.94	0.96	0.98	1.00	1.00	0.99	0.99
USD / SEK	8.67	8.64	8.63	8.69	8.68	8.59	8.53	8.39
AUD / USD	0.74	0.73	0.74	0.74	0.75	0.75	0.77	0.79
NZD / USD	0.71	0.72	0.73	0.73	0.74	0.74	0.75	0.77
USD / NOK	8.60	8.55	8.54	8.65	8.68	8.64	8.39	8.13
USD / ZAR	15.36	15.45	15.75	15.50	15.25	15.00	14.50	14.00
USD / BRL	5.48	5.60	5.70	5.70	6.00	5.70	5.70	5.30
USD / MXN	20.5	20.5	20.3	20.0	20.0	20.5	21.5	21.5
USD / COP	3877	3700	3900	3800	3600	3500	3600	3800
USD / CLP	792	810	780	760	720	740	760	780
USD / CNY	6.39	6.35	6.30	6.25	6.20	6.15	6.00	5.90
USD / KRW	1181	1165	1150	1140	1130	1120	1110	1100
USD / INR	74.4	73.5	73.2	73.0	72.9	72.7	72.5	72.2
USD / SGD	1.35	1.34	1.33	1.33	1.32	1.32	1.31	1.30
USD / TWD	27.8	27.5	27.2	26.9	26.8	26.8	26.6	26.5
USD / MYR	4.15	4.15	4.10	4.05	4.00	3.95	3.80	3.65
USD / IDR	14253	14250	14200	14150	14050	14000	13850	13800

Other crosses

End of period:	Nov 10/21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q2 23	Q4 23
CADJPY	91.6	91.9	89.8	89.9	88.5	87.7	85.5	83.3
AUDCAD	0.92	0.91	0.94	0.95	0.98	0.98	1.01	1.04
GBPCAD	1.68	1.65	1.70	1.69	1.70	1.72	1.76	1.80
EURCAD	1.43	1.41	1.45	1.43	1.43	1.43	1.47	1.52
EURJPY	131	130	130	129	127	125	125	127
EURGBP	0.85	0.86	0.85	0.85	0.84	0.83	0.84	0.85
EURCHF	1.06	1.07	1.08	1.09	1.10	1.10	1.11	1.14
EURSEK	9.98	9.85	9.75	9.65	9.55	9.45	9.55	9.65
EURNOK	9.91	9.75	9.65	9.60	9.55	9.50	9.40	9.35

Key indicators – Latest data point

End of period:	Quarterly real GDP (y/y %)	CPI (y/y %)	Current acct (% of GDP)	Central bank rate (%)
US	4.9	6.2	-3.4	0.125
Canada	12.7	4.4	0.6	0.250
Eurozone	3.7	3.4	3.1	0.000
Japan	7.6	0.2	3.9	-0.100
UK	23.6	3.1	-2.3	0.100
Switzerland	7.7	1.2	3.0	-0.750
Sweden	9.7	2.5	5.8	0.000
Australia	9.6	3.0	3.3	0.100
New Zealand	17.0	4.9	-1.8	0.500
Norway	6.1	4.1	9.9	0.250
South Africa	19.3	5.0	4.6	3.500
Brazil	12.4	10.2	-1.3	7.750
Mexico	19.6	6.0	3.0	4.750
Colombia	17.6	4.5	-4.6	2.500
Chile	18.1	5.3	-1.1	2.750
China	4.9	0.7	1.9	3.850
South Korea	4.0	3.2	5.7	0.750
India	20.1	4.3	0.4	4.000
Singapore	6.5	2.5	18.8	n/a
Taiwan	3.8	2.6	15.1	1.125
Malaysia	16.1	2.2	4.8	1.750
Indonesia	3.5	1.7	-0.1	3.500

CAD

Katherine Judge and Avery Shenfeld

Tempering of market BoC optimism to unravel CAD gains

Q4 2021: 1.24 | Q1 2022: 1.28 (USDCAD)

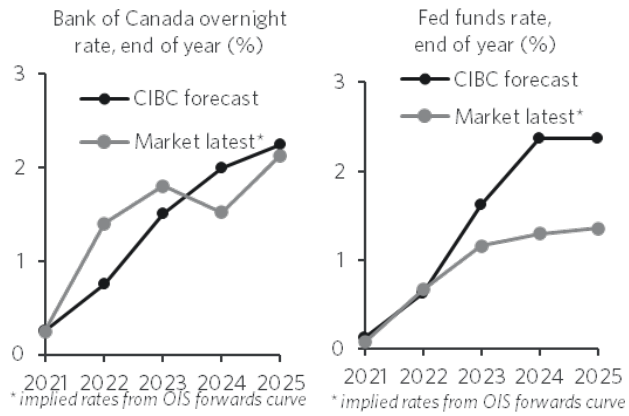
While the loonie had been strengthening as the market pulled forward expectations for Bank of Canada tightening, it was oddly quiet when rates took a further jump on a hawkish BoC statement and policy report. The reaction in the rates market may have reflected one-sided positioning, as 2-year yields subsequently retraced much of that jump. With the BoC redefining the output gap to exclude capacity temporary offline due to supply chain and other disruptions, we pulled forward our forecast for BoC tightening, and we now see the Bank raising rates starting in Q3 2022, with an additional 25bps hike in Q4, and 75bps of hikes in 2023.

But that remains well below what the market has priced in (Chart 1). The BoC already looks too optimistic in its growth forecast, with monthly GDP data pointing to a Q3 result well below the Bank's 5.5% projection. The Bank's own research has pointed to the heavy level of household debt in Canada as a reason why the economy will be more sensitive to rising rates.

With the US seeing more wage and price inflation, and ahead of Canada in its GDP recovery, we have the Fed hiking a bit more than the BoC (150bps in total) over 2022-23. Both wage and price inflation trends have been hotter south of the border. Canada has outperformed on the jobs count, but will see increased labour force availability as immigration ramps up, and hasn't seen as much evidence as the US of permanent departures from the workforce. Hiring in Canada could also be impacted in the near term by the reduced availability of wage subsidies. Moreover, unlike Canadians, Americans have much of their mortgage debt locked in for 30 years and are therefore not impacted by a turn in rates.

We see USDCAD drifting above the 1.30 mark next year, as it becomes clear that Canada's central bank will not be outgunning the Fed, and as oil prices retreat from recent highs. Softer crude prices and a return to Canada's usual travel deficit as tourism restarts will weigh on the country's trade balance, which has been supportive for the loonie in recent quarters.

Chart 1: Markets too optimistic on BoC hikes in 2022-23 (l); not pricing in enough from the Fed post-2022 (r)



Source: Bloomberg, CIBC

USD

Bipan Rai

Green light for the greenback as Fed enters steep tapering cycle

Q4 2021: 95.3 | Q1 2022: 96.3 (DXY)

On a trade-weighted basis, the USD has been consolidating over the past month. We're still constructive over the coming year, and there are a few important themes to keep tabs on in the period ahead.

The great 'repricing' of central banks in the short rates space has made relatively little waves in the broad USD market. That could be because much of the shift in central bank pricing has been for the smaller DM central banks that have benefitted from stronger terms of trade. There hasn't been as pronounced of a shift for large DM central banks – which is where the largest weights are for the USD basket. We're still circumspect with the degree to which the smaller DM central banks are being priced for next year, and would expect that corrective moves there should buttress the USD even more in the quarters ahead.

Second, the Fed has begun to taper its monthly asset purchases. Unlike the 2014 edition of its taper, the Fed will be reducing its asset purchases on a monthly basis instead of whenever it meets. We're still of the view that the additional supply for the market will lead to higher nominal yields in the long-end and further support the USD.

Third, extant positioning in the FX market still implies that the USD is already the favoured long. Unlike the first two themes, this represents a risk to our view in the near term. Nonetheless, positioning in the FX market is generally a tactical theme and we'd still view any USD weakness as an opportunity to layer into opportunistic hedges, especially for those that are adversely impacted by a stronger USD over the long term.

EUR

Jeremy Stretch

Laggard ECB to dampen euro sentiment

Q4 2021: 1.14 | Q1 2022: 1.13 (EURUSD)

The 16 December ECB meeting is likely to prove pivotal to the EUR's 2022 trajectory. The meeting is accompanied by updated forecasts, including inflation (HICP), out to 2024 for the first time. Headline inflation is running at levels not seen in more than a decade, and the hawks on the committee, led by the soon to depart Bundesbank President Weidmann, continue to detail that "upside risks predominate". But the main protagonists on the ECB Governing Council, led by President Lagarde, continue to view these price pressures as largely transitory. Lagarde has suggested that the ECB should "not overreact to supply shortages or rising energy prices". The view that core prices will be relatively well behaved will help maintain medium run ECB policy inertia.

The ECB has indicated that the existing emergency bond buying programme will remain in place until the pandemic emergency is over. As the process has a clear timeline, March 2022, and overall purchase envelope, €1850bn, expect PEPP balance sheet expansion to conclude in line with that timetable. However, ECB apprehension over the maintenance of favourable financing conditions, and concerns over peripheral spread widening, point towards the ECB utilising the Asset Purchase Programme to maintain bond purchases into 2023.

While hawks and doves will debate the medium term assumptions, we expect them to maintain bond purchases well beyond the end of next year. In view of the ECB sequencing assumptions, that would leave rates on hold well into 2023, in contrast to the US. That policy gap underscores why we continue to favour EUR underperformance versus the USD, and look for EUR/USD retreating towards 1.10 in 2022.

JPY

Jeremy Stretch

Extended easy BoJ monetary policy suggests weaker yen ahead

Q4 2021: 114 | Q1 2022: 115 (USDJPY)

While the RBA recently moved away from yield curve control, it seems unlikely that the BoJ is set to follow suit anytime soon. Following a meeting between BoJ Governor Kuroda and PM Kishida, post the recent LDP election victory, the former acknowledged that not only does the bank remain committed to its 2% CPI target, it also will maintain YCC, even beyond Covid. The perpetuation of an ultra-easy BoJ policy stance is set to leave Japan alongside the eurozone and Switzerland as extending long term policy inertia, a scenario which should continue to leave the JPY on the defensive.

Post the re-election of the LDP, we can expect another round of fiscal stimulus. Press reports suggest a potential injection of around JPY35trn, which could even include cash handouts to youths and children. While we expect Q3 weakness to give way to a solid rebound in Q4 GDP as the economy re-opens, the extension of yield curve control will see a sizeable widening in UST-JGB 10 year spreads, providing the rationale for ongoing outflows of capital looking for higher returns overseas.

Admittedly, one risk to our weaker yen scenario that bears watching is the sheer scale of existing JPY shorts. Speculative investors have continued to add to those positions over recent weeks, and leveraged shorts are threating extremes not seen since December 2018. The scale of the position skew risks a JPY corrective rally should risk sentiment prove to become materially compromised into year-end, but we would still maintain our medium term outlook for a weaker yen into 2022.

GBP

Jeremy Stretch

Soft macro backdrop to weigh on Sterling

Q4 2021: 1.33 | Q1 2022: 1.33 (GBPUSD)

UK interest rate volatility has exploded over recent weeks as the market reacted to increasingly vigorous warnings from BoE members regarding the prospect of early rate hikes. Going into the November MPC decision, the market had not only priced in more than 15bps of tightening, reversing the March 2020 emergency rate cut, but it also had priced in a total of 125bps of hikes by the end of 2022. The market paid insufficient attention to BoE Governor Bailey's warnings that "we will have to act" were loaded up with caveats, namely such action would require "medium-term inflation and medium-term inflation expectations" to be at risk.

A by-product of the market ramping up rate hike expectations proved to be a correction in speculative Sterling positioning. Leveraged players pared shorts from 10-month highs while real money investors moved back net long of Sterling, with holdings reaching three-month highs. But the risk of pre-emptive monetary tightening compromising UK recovery dynamics has proved to weigh upon trade-weighted Sterling.

The BoE failed to pull the rate trigger in November, in line with our pre-meeting call. We expect rates to be hiked by 15bps in February, reversing the March 2020 emergency cut. However, we expect the BoE to be more circumspect in 2022 than what is still assumed by the market, which is pricing in 95bps of hikes in the next 12 months.

A slowing macro environment and relatively contained inflation expectations points towards a less aggressive rate cycle. Rising prices risk disposable incomes being compromised prior to an already announced tax hike. That combination points to consumption headwinds which will compromise the real economy. The risk of advancing UK/EU trade frictions also points towards increasing GBP headwinds into early 2022. As a consequence, we have revised down our Sterling outlook.

CHF

Jeremy Stretch

SNB Monetary policy accommodation behind expected CHF weakness ahead

Q4 2021: 1.07 | Q1 2022: 1.08 (EURCHF)

The modest increase in Swiss sight deposits in the first week of the month, despite the fact that EUR/CHF traded to new fresh post-pandemic lows, points towards the SNB being relatively reluctant to push back against near-term CHF gains, not least as the EUR continues to be undermined by the prospect of ongoing dovishness. But that has not stopped real money investors from extending net CHF shorts over recent weeks. Indeed, after moving net short of the CHF in mid-September, for the first time since March 2020, the overall short CHF skew has extended to levels not seen since December 2019.

Although sight deposits are not a complete measure of central bank intervention, it does appear that the central bank is more hesitant about stemming near-term CHF gains. It might be welcoming some appreciation given that its impact on import prices could lean against the recent uptrend in the CPI. Having already reached the 2018 cyclical high at 1.2% in October, prices looks set to accelerate further in the near term. But if as we expect, inflation remains below target over the medium term, the tolerance for a stronger CHF might not prove long lasting. Hence we expect USD/CHF to reverse the early Q4 correction.

SEK

Jeremy Stretch

Riksbank tightening expectations to support SEK momentum

Q4 2021: 9.85 | Q1 2022: 9.75 (EURSEK)

The SEK has proven to be a material outperformer over the last month. The catalyst has been a material reassessment of interest rate expectations. From pricing rates remaining on hold as recently as three months ago, the market has now moved to price in almost 40bps of tightening in the course of the next 12 months.

Although the economic surprise index has eased from near six-month highs, the economic tendency survey remains near record highs, and Q3 GDP materially beat expectations. Forward looking sentiment, in terms of the PMI indices, remains supportive. Indeed, the compositive PMI has only dipped below 65 once in the last seven months, suggesting that macro activity looks set to remain firm.

Of course, as a small open economy, there are concerns in relation to any spillover effects from global supply chain disruptions. Although the manufacturing PMI moderated in October, the underlying dynamics, including exports and domestic orders, remained constructive, while the delivery times component eased from September extremes. Despite the Riksbank business survey warning about the impact of supply side disruptions, manufacturing sentiment rebounded in the October economic tendency survey.

The Swedish CPI is now expected to remain above 2% in 2022, up from previous median assumptions of prices at 1.6%. That will help validate the need for the Riksbank to act soon, supporting additional SEK gains. A final justification for action comes via ongoing real estate concerns. With home price growth remining in excess of 10%, the central bank will remain mindful of rising financial sector imbalances, underlining the need for a modest tightening bias, and supporting further SEK gains.

Commodity FX
NOK

Jeremy Stretch

NOK gains to continue in line with Norges Bank tightening

Q4 2021: 9.75 | Q1 2022: 9.65 (EURNOK)

The NOK has proved the top performing major versus the US and EUR over the last 3m and 12m. Key to the outperformance has been the combination of a constructive fiscal outlook, robust recovery dynamics which have encouraged monetary tightening, and oil price gains. In terms of the latter, the one month correlation between Brent Crude and the NOK remains close to decade level highs.

The rebound in macro activity prompted the Norges Bank to become the first major developed market central bank to hike when they took rates to 0.25% in September. Although the bank passed up the opportunity to tighten further at its November meeting, that was very much expected. We look for another 25bps tightening to come at the 16 December meeting, in line with the updated Monetary Policy Report.

While the macro rebound and uptick in the oil sector are seen to justify policy action, the obvious differential between the Norges Bank and most other major central banks is that the tightening cycle is framed by an inflation profile which is set to remain below target over the forecast horizon. Our global base case also has crude oil prices reversing some of its gains in 2022, which could have the central bank pushing back a bit on the degree of tightening ahead. Although we continue to expect NOK gains versus the EUR, they are set to be less aggressive in the next 12 months compared to the last.

AUD

Patrick Bennett

AUD: Mixing its performance

Q4 2021: 0.73 | Q1 2022: 0.74 (AUDUSD)

Over the last month, AUD has gained against the funding currencies of JPY and EUR, and is also firmer against the USD, although it has lost ground to the NZD, as rate differentials have widened. In the coming month, we expect flat to positive AUD performance against the USD as the economy recovers from lockdowns, and for underperformance against the NZD to extend.

The RBA view for some time has been that economic recovery from lockdowns would be swift. Though the bank was also firm in its view that a return to full employment and thus wage growth and consumer price inflation, would take considerably longer. A higher than expected print for 3Q CPI saw the market bring forward an expected first rate hike into 2022, against the RBA guidance of 2024. We expect the first hike in 1Q 2023.

Although RBA conceded the higher CPI result, removed specific date guidance, and ended yield curve control of the April 2024 bond, they pushed back expectations of an earlier rate rise. AUD gains through October were pared at the time and we now expect they should track the economic data out of the lockdowns in the coming weeks. The next key data is 3Q wage data on November 17th.

For AUD overall, that the RBA will be one of the later major central banks to tighten, need not be a dramatic weight on the currency, so long as the economy is recovering with low-inflation activity.

Previous concerns over tensions between China and Australia have not gone away, but trade numbers out of both economies show that Chinese demand for industrial commodities continues and that Australia remains its major source.

NZD

Patrick Bennett

Expectation of RBNZ hikes provides support

Q4 2021: 0.72 | Q1 2022: 0.73 (NZDUSD)

As the RBNZ began the process of policy normalisation, hiking the cash rate 25bps in October, the NZD consolidated what had already been a strong performance amongst major currencies since the middle of the year.

With the RBNZ to hike again this month and continue that process next year, and the cash rate expected to reach 1.50% from the current 0.50%, we expect rate differential support for the NZD to show via appreciation on a number of crosses.

We recommend being buyers of weakness in NZD vs AUD, EUR and JPY. Key driver for moves will be the divergence in monetary policy, both actual and outlooks. We exclude trades vs the USD at this point as the Fed is closer than the others mentioned to normalisation. Still, we also highlight moderate support for NZD/USD down to 0.7000, which was the area of previous highs. More major support will be found ahead of 0.6800-0.6850.

The transmission mechanism from higher rates to the currency is not always straightforward. All else equal, if activity was not also picking up, higher cash rates would be a headwind to asset prices and the currency. In the case of the New Zealand, activity has been strong and is expected to remain so. That has been underpinned to-date by fiscal and monetary support, and through strong external demand that has lifted the terms-of-trade to a record.

ZAR

Jeremy Stretch

ZAR sentiment challenged by stagflation dynamics

Q4 2021: 15.45 | Q1 2022: 15.75 (USDZAR)

After a brief flirtation below the 13.50 threshold into the end of H1, the ZAR has been the second worst performing global currency thus far in H2, as only the BRL has witnessed a greater degree of depreciation. That has developed as international investors have largely abandoned domestic bonds. The three-month moving average of foreign bond purchases has dipped to all-time lows, beyond 2020 extremes. While international investors have steered away from domestic bonds, speculative ZAR holdings were reduced by around two thirds over the same period.

The reduction in appetite for South African paper comes as real yields continue to be compromised. Rising domestic inflationary influences point towards real yields continuing to compress. Having peaked above 6% in Q1, they are set to dip below 4%, as CPI looks set to advance from September's 5.0% amidst ongoing food and energy price gains.

Having moved beyond the mid-point of the 3-6% SARB target range in August, prices risk threatening the top of the price corridor into year-end. The recent ZAR depreciation will exacerbate the jump in the global oil price, as WTI has gained almost 30% in local currency terms across the period. While inflation expectations have yet to become materially de-anchored, signs of an uptick in wage deals, as the metalworkers union agreed to a 5-6% hike, point towards the need for central bank action to restrain inflationary pressures. While a rate hike at the November meeting is likely to be a close call, the prospect of at least 75bps of tightening in the next 12 months risks materially compromising the growth trajectory, adding to near-term ZAR headwinds. Hence we expect a re-test of 2021 highs in the next six months.

LATAM FX
MXN

Luis Hurtado

Banxico likely to remain the regional outlier

Q4 2021: 20.5 | Q1 2022: 20.3 (USDMXN)

The TIIE curve endured a 10bps average drop in the 3M-1Y range following the Fed and the weaker economic activity numbers last week. Although a welcome adjustment, we believe short-terms are not incorporating the non-negligible odds of a rate pause in the hiking cycle in 2022. The market is still pricing over 100bps in rate increases for the next three months and over 250bps in the one year range. Such a trajectory implies not only continuous rate increases for the next eight meetings, but also an acceleration of the tightening cycle in the near future. We find it difficult to believe that outcome will be achieved given the division among the board, Arturo Herrera (AMLO's 4th nominee at the board) replacing Alejando Diaz de Leon in January, and the negative surprises in recent economic activity numbers.

We expect Banxico to increase the overnight rate by only 25 bps this week, and by another 25bps in December, leaving the door open for a potential pause in 2022 H1. Looking at the peso, we favour long USD/MXN positions at 20.30 with a 20.80 target and a 20.10 stop loss.

BRL

Luis Hurtado

Fiscal risks support aggressive tightening cycle

Q4 2021: 5.60 | Q1 2022: 5.70 (USDBRL)

The constitutional amendment that limits annual payments of court-ordered debts resumes discussion in congress this week. We expect headline volatility to resurface as some parties that favoured the proposal in the first round are showing signs of a change in position, creating uncertainties in the Lower House and the Senate. A defeat by the government could push the Bolsonaro administration to implement creative ways of financing its social aid program next year.

Remember that the main impact on markets comes from the reputational hit to the government from breaching a rule that was designed to ensure fiscal austerity after several years of a spending spree on the part of previous governments. Moreover, with the onset of the general election cycle, this situation could set a precedent, opening the door for other expenses outside the spending cap.

On the monetary policy front, the BCB has already entered into damage control mode, increasing the Selic rate by 150bps in October and signalling a similar hike in the last meeting of the year. Hence, we expect the Selic rate to end the year at 9.25% and to reach 11.25% by the end of Q1 2022, and we revised our year end USD/BRL forecast to 5.60 from the previous 5.30.

CLP

Luis Hurtado

BCCh to increase overnight rate by at least 125bps in December

Q4 2021: 810 | Q1 2022: 780 (USDCLP)

Chilean assets recovered some ground last week as a far-right wing candidate gained significant traction, overtaking Sebastian Sichel's second place in the polls and even challenging leftist Gabriel Boric's lead ahead of the November 21st presidential election. The senate is still set to vote on the pension withdrawal bill amid some opposition members stating they will not back the law. However, we still maintain a high level of caution as a the vote remains a close call.

On the monetary policy front, October headline inflation increased to 6.0% y/y (vs 5.3% y/y in September), 0.4 percentage points about market consensus. Core prices showed a similar trend, jumping to 5.06% from the previous 4.38% y/y. With robust household consumption expected to continue in the short term and discussions about another round of pension funds withdrawal ongoing in congress, we expect the BCCh to maintain its current pace of rate increases, and hike the overnight rate by at least 125bps in December.

COP

Luis Hurtado

Banrep accelerates tightening cycle

Q4 2021: 3700 | Q1 2022: 3900 (USDCOP)

Banrep increased the overnight rate by 50bps to 2.50%, 25bps more than expected by consensus, but in line with our forecast. Banrep once again left the door open for further rate increases as inflationary pressures remain in place and both core and headline inflation are above target. Moreover, the central bank revised its GDP growth and inflation forecasts significantly higher. Hence, we now expect the year-end overnight rate to land at 3.00%.

Looking at USD/COP, with Banrep confirming an acceleration of the tightening cycle, we maintain our bias towards selling USD/COP spikes at 3900. However, despite the decisively hawkish rate announcement, we do not expect a significant downward trend in USD/COP, as the electoral cycle will contaminate market expectations going forward. Hence, we have revised our previous USD/COP year-end target to 3700 from the previous 3600.

Asia FX
CNY

Patrick Bennett

Appreciation continues at steady but modest pace

Q4 2021: 6.35 | Q1 2022: 6.30 (USDCNY)

The current economic and fundamental landscape in China throws up any number of concerns or cautionary flags. They include slowing economic momentum, energy supply issues and curbs on electricity usage, China Evergrande and property concerns more generally, geo-political concerns, and lingering trade tensions.

Witnessing the hitherto stability of USD/CNH, and recently a renewed push lower in the market, fairly prompts question as to whether the strength of the CNH vs the USD – and it is even stronger on trade-weighted measures, can be validated. We believe it can.

Following a sustained downtrend in USD/CNH from May to December of last year, spot has settled inside a range of 6.3500-6.6600. A corrective rebound off lows of 6.3525 in late May, reached 6.5287 in July, before subsequently breaking below 6.4198 in mid-October. The significance of the 6.4198 break is that it marked a 61.8% retracement of the corrective rebound. Below that level, from a technical perspective, suggests the major downtrend has resumed.

Present levels of USD/CNH are somewhat in line with a long-held relationship between USD/CNH and the spread between China and US 10-yr. yields.

Investor demand for Chinese bonds has been strong over the last months and is a long-term currency support. That will only increase, albeit subject to hedging, when Chinse bonds are included in global indices from this month. Estimates are of around $130bln of demand over the 36 months to October 2024, which is the end of the initial inclusion period.

In light of USD/CNH stability and with the USD stronger against a number of other major currencies, the trade-weighted value of the Chinese currency has appreciated. It is around 5% stronger ytd versus a 2% gain vs the USD.

A significant development is related to higher commodity prices generally, and energy import costs more specifically. Even as commodity prices have increased; since June, Chinese imports in CNY terms have expanded at a slower pace. While there may be supply issues at play, we suggest that the stronger currency, both trade-weighted and vs the USD is helping to reduce the import bill. Potential downstream damping of domestic prices pressure will also be welcome.

China runs a strong trade and current account surplus. Our view on trade is that China's export competitiveness has rarely been about the exchange rate, and more about its cost of labour advantage, and via other channels, many addressed by US trade hawkishness. In light of higher import costs, and despite Chinese policy makers saying earlier this year that the currency would not be used to dampen the domestic impact, perhaps a shift has taken place. That would be one which provides validation to CNH appreciation now, and for gains to continue so long as global input prices remain elevated.

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