Economics and FICC Strategy

MONTHLY FX OUTLOOK

December 20, 2021

US dollar rally has a final act to come

Currency	What's changed
USD	The Fed is poised to start hiking rates in Q2 2022, and building market expectations for higher terminal rates will support a final act for the USD rally.
CAD	Loonie sees modest further depreciation on USD gains as markets price matching rate hike cycles across the Canada-US border.
EUR	Ongoing balance sheet expansion underlines that the doves remain in the ascendancy at the ECB, leaving the euro on the defensive in 2022.
GBP	A moderating growth backdrop, UK/EU trade frictions, and a less aggressive UK rate cycle than that currently priced suggests Sterling weakness in 2022.
JPY	As it looks increasingly likely that BoJ rates are set to remain at current levels through 2023, JPY won't see any upside in 2022.
Commodity FX	Monetary policy normalisation continues in New Zealand, while a more positive RBA outlook suggests the first rate hike in Australia will be delivered in Q4 2022.
LATAM FX	Central banks maintain hawkish forward guidance. LATAM currencies, with the exception of the CLP, won't reverse the depreciation seen in H2 2021.
FX Asia	PBoC pro-active monetary policy, demand for Chinese bonds, and benefits of a steady or stronger currency continue to support CNY and CNH outperformance.

Currency outlook

End of period:	Dec 17/21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
USD / CAD	1.29	1.29	1.30	1.32	1.31	1.31	1.31	1.30	1.29
EUR / USD	1.12	1.11	1.10	1.10	1.10	1.11	1.12	1.13	1.15
USD / JPY	114	115	116	115	114	113	112	111	110
GBP / USD	1.32	1.31	1.29	1.30	1.32	1.34	1.34	1.35	1.36
USD / CHF	0.92	0.95	0.97	0.98	0.99	0.99	0.99	0.99	0.99
USD / SEK	9.13	9.01	8.91	8.77	8.64	8.56	8.53	8.50	8.39
AUD / USD	0.71	0.73	0.74	0.75	0.76	0.77	0.78	0.79	0.80
NZD / USD	0.68	0.70	0.71	0.71	0.72	0.74	0.74	0.75	0.76
USD / NOK	9.03	8.87	8.82	8.73	8.64	8.51	8.39	8.27	8.13
USD / ZAR	15.88	16.25	16.25	15.80	15.50	15.25	15.10	14.85	14.50
USD / BRL	5.69	5.70	5.70	6.00	5.70	5.90	5.70	5.50	5.30
USD / MXN	20.8	21.0	22.0	22.0	21.5	21.0	21.5	21.3	21.5
USD / COP	4028	4200	4100	4000	4000	3900	3800	3800	3800
USD / CLP	845	780	780	800	800	790	780	780	780
USD / CNY	6.38	6.30	6.25	6.20	6.15	6.05	6.00	5.95	5.90
USD / KRW	1181	1165	1155	1150	1140	1130	1120	1110	1100
USD / INR	76.1	75.5	74.5	74.0	73.0	72.5	72.0	72.0	71.8
USD / SGD	1.37	1.34	1.33	1.32	1.32	1.31	1.31	1.30	1.30
USD / TWD	27.8	27.4	26.9	26.8	26.8	26.7	26.6	26.5	26.5
USD / MYR	4.22	4.10	4.10	4.00	3.95	3.90	3.80	3.70	3.65
USD / IDR	14368	14250	14150	14050	14000	13900	13850	13820	13800

Other crosses

End of period:	Dec 17/21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
CADJPY	88.2	89.1	89.2	87.1	87.0	86.3	85.5	85.4	85.3
AUDCAD	0.92	0.94	0.96	0.99	0.99	1.01	1.02	1.02	1.03
GBPCAD	1.71	1.69	1.68	1.72	1.73	1.76	1.76	1.76	1.75
EURCAD	1.45	1.43	1.43	1.45	1.44	1.45	1.47	1.47	1.48
EURJPY	128	128	128	127	125	125	125	125	127
EURGBP	0.85	0.85	0.85	0.85	0.83	0.83	0.84	0.84	0.85
EURCHF	1.04	1.05	1.07	1.08	1.09	1.10	1.11	1.12	1.14
EURSEK	10.26	10.00	9.80	9.65	9.50	9.50	9.55	9.61	9.65
EURNOK	10.16	9.85	9.70	9.60	9.50	9.45	9.40	9.35	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	6.8	-3.4	0.125
Canada	4.0	4.7	0.2	0.250
Eurozone	3.7	4.1	2.9	0.000
Japan	1.4	0.1	3.4	-0.100
UK	6.6	5.1	-2.3	0.250
Switzerland	3.3	1.5	3.0	-0.750
Sweden	4.7	2.8	5.9	0.000
Australia	3.9	3.0	3.9	0.100
New Zealand	17.4	4.9	-1.8	0.750
Norway	6.2	3.5	9.8	0.500
South Africa	3.7	5.0	4.6	3.750
Brazil	4.0	10.7	-1.3	9.250
Mexico	4.5	7.4	1.0	5.500
Colombia	13.2	5.3	-5.1	3.000
Chile	17.2	6.7	-3.5	4.000
China	4.9	2.3	1.9	3.850
South Korea	4.0	3.7	5.7	1.000
India	8.4	4.9	0.4	4.000
Singapore	7.1	3.2	19.5	n/a
Taiwan	3.7	2.8	14.3	1.125
Malaysia	-4.5	2.9	3.8	1.750
Indonesia	3.5	1.7	0.2	3.500

CAD

Katherine Judge and Avery Shenfeld

Loonie to start the New Year with a whimper

Q1 2022: 1.29 | Q2 2022: 1.30 (USDCAD)

The loonie was on a rollercoaster at the onset of the discovery of the omicron variant but has since come full circle, and is sitting marginally weaker. On the domestic front, the outperformance in Canada's labour market shows that slack is rapidly vanishing, and inflation is well above target.

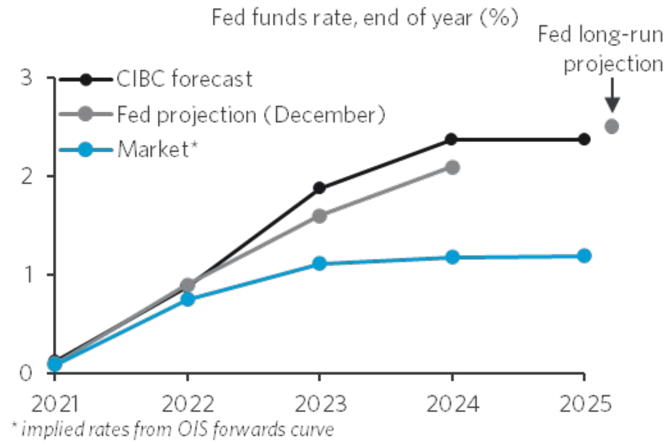
While an omicron-stalled recovery stands in the way of a January Bank of Canada move, assuming a spring thaw in Covid, look for April to mark the start of a now well-telegraphed tightening cycle. Omicron is likely to see a set back in services employment and a weak Q1 GDP print, but demand will likely come roaring back once this wave passes. Labour market indicators could close in on pre-Covid levels by spring, even if real GDP is still falling well short of its prior trend line.

Our outlook for 150 bps in BoC rate hikes in the next two years, divided equally between 2022 and 2023, is a bit more drawn out than market pricing. But it's the likely Fed pace that will be the biggest surprise. That's not in the 75 bps we assume for the Fed in 2022, but what lies beyond, with the market not yet buying into the FOMC's "dot" forecast, or our marginally more hawkish call (Chart). An even starker difference lies in the long-run, where markets appear to be expecting the fed funds rate to settle at 1 ½%, well below the prior cycle's terminal rate, and the Fed's own long-run projection of 2.5%. We expect that as QE tapering winds down and the first Fed hike is delivered in Q2, markets will move to price in more Fed action, pushing USDCAD to 1.32 in Q3 2022.

Also weighing on the loonie in early 2022 will be a lack of upside in commodities. Demand for oil will be hampered in the near term by the spread of omicron globally. Thereafter, the potential for OPEC+ to ramp up oil supply during the recovery will put a cap on prices. A return to more travel will also bring back Canada's typical deficit in tourism services trade.

By late 2022, we expect to see a shift in the tides for the loonie, as the market will likely have come around to our view on Fed hikes for the post-2022 period, and the broad trend in the USD could therefore be towards a greenback depreciation as other advanced economy central banks move to normalize rates. However, CAD will still only be a marginal beneficiary of that trend, as the bigger news will be a turn towards tighter monetary policy in lagging regions like the eurozone.

Chart 1: Markets still underestimating Fed tightening post-2022



Source: Bloomberg, Federal Reserve, CIBC

USD

Bipan Rai

One last hurrah for the USD

Q1 2022: 97.6 | Q2 2022: 98.5 (DXY)

On the surface, the outcome of the December FOMC meeting was decidedly hawkish. The Fed elected to accelerate its taper of asset purchases (from $15bln per month to $30bln), remove the reference to 'transitory' when referencing inflation in the statement, and acknowledge that the risks to price pressures were higher. Additionally, the latest round of dot projections show the Fed lifting off three times in 2022, as opposed to just once in the September projections. The USD slid after the FOMC, but that's largely because the markets had anticipated most of the changes and priced them in beforehand.

Looking ahead, we still see upside for the USD into next year. From an endogenous perspective, the USD can rally further as markets begin to price the implied terminal rate for the Fed higher. And there's good reason to believe that this will happen considering that we're expecting a sharp reacceleration in activity following the winter Covid wave. That could require some patience given the move that we've had in the trade-weighted USD over the second half of this year, but any consolidation or retrenchment should be regarded as an opportunity to adjust hedges.

EUR

Jeremy Stretch

Dovish ECB to keep euro on the defensive in 2022

Q1 2022: 1.11 | Q2 2022: 1.10 (EURUSD)

The latest ECB meeting detailed that the central bank will maintain bond purchases through 2022, albeit at a pace that will progressively decelerate, on a step-by-step basis. While the emergency PEPP programme will be allowed to expire at the end of Q1, the central bank will up its purchases under the Asset Purchase Programme from the current €20bn per month to €40bn per month in Q2, easing back to €30bn in Q3, and then reverting back to €20bn in Q4.

Some looking for up to €50bn in APP purchases were disappointed by what was announced, but the fact that the APP commitment is open-ended is significant; since the Governing Council only expects to raise rates after the end of net bond purchases. Moreover, PEPP proceeds will be reinvested until 2024, maintaining the balance sheet. Indeed, the ECB stand by to reinstitute the PEPP process should it prove necessary. Thus, despite the moderation in bond purchases, ongoing balance sheet expansion underlines that the doves remain in the ascendancy at the ECB.

The new ECB staff forecasts, reaching out to 2024 for the first time, show a materially firmer inflation profile compared to the September estimates. While 2022 HICP is now expected to be 3.2%, compared with just 1.7% previously, the bank assumes inflation in both 2023 and 2024 will remain below the 2% target threshold. Remember that the ECB President has determined that CPI needs to reach the threshold prior to the mid-point of the three-year forecast profile. The market is currently pricing nearly 10bp of tightening in Q4 2022, which appears mispriced and prone to correct if, as we expect, growth and inflation results in 2022 leave the ECB on hold.

Unless fiscal policy proves significantly more expansive than anticipated, a long period of ECB policy inertia, set against firming expectations for Fed hawkishness, underlines our bias for the EUR to remain on the defensive in 2022.

JPY

Jeremy Stretch

Laggard BoJ reinforces expectation of yen softness in 2022

Q1 2022: 115 | Q2 2022: 116 (USDJPY)

The sizeable scale of extant JPY short positions has long been seen as an impediment to additional JPY weakness. However, since early November we have seen real money shorts pared by more than 40% while leveraged holdings have more than halved. The latter comes after leveraged players had extended net JPY shorts to near three-year highs. The reduction in the short speculative skew comes as we have seen USD/JPY correct from levels not seen since Q1 2017. Contingent to the unwind in JPY shorts and rebound in Yen valuations has proved to be the correction in UST-JGB spreads. Beyond external risk sentiment which risks influencing risk barometers such as AUD/JPY, we would continue to view UST-JGB dynamics as remaining integral to USD/JPY performance.

Japanese investors materially unwound foreign bonds holdings into the end of November and early December; the weekly reduction in the former was the most aggressive since April. In our estimation, the correction was likely a function of early omicron-related risk uncertainty. We do not anticipate that the unwind in foreign asset purchasing appetite will persist. Indeed, we expect continued interest in exporting capital across the year ahead, omicron risks notwithstanding.

We expect the BoJ, in line with the ECB and SNB, to remain as a policy laggard. Indeed, it seems increasingly likely that rates will remain at current levels through 2023. While the BoJ stand ready to do more in terms of stimulus, in reality the onus for stimulus is more likely to fall on fiscal action from the new Kishida administration. Look for the government to approve a new JPY 36trn supplementary fiscal budget in the current Parliamentary session. Those measures should provide at least some support against external headwinds, but are unlikely to be sufficient to boost JPY valuations.

GBP

Jeremy Stretch

GBP to weaken as markets expecting too much from BoE

Q1 2022: 1.31 | Q2 2022: 1.29 (GBPUSD)

After confounding the market and not hiking in November, the Bank decided to hike by 15bps in December, reversing the emergency cut from March 2020. The November meeting minutes detailed that "provided the incoming data, particularly on the labour market, were broadly in line with the central projections in the November Monetary Policy Report, it would be necessary over coming months to increase Bank Rate in order to return CPI inflation sustainably to the 2% target."

The labour market data met the conditions for tightening, and the Bank felt it prudent to hike, in large part in order to preclude inflationary pressures from becoming de-anchored. The BoE was clearly spooked by outsized and broadening CPI pressures. The MPC has now conceded that CPI looks set to test 6% into spring. As a consequence, the Bank clearly felt the need to act now to show its colours. But in reality, the 15bps move was largely symbolic, and aimed at sending a signal to dampen inflation expectations, as only around 25% of mortgage holders will be immediately impacted by an increase in floating mortgage rates.

While the Bank has clearly underlined its determination to adhere to its CPI mandate, we would not expect a material degree of 2022 policy tightening. Moderating growth, and a topping out in energy prices, should limit the inflation upside, and preclude the BoE from being pressed to aggressively tighten in the year ahead. The combination of a moderating growth backdrop, ongoing UK/EU trade frictions, and a less aggressive UK rate cycle than that currently discounted, underlines scope for Sterling headwinds to persist.

CHF

Jeremy Stretch

SNB Intervention to keep a lid on CHF valuations ahead

Q1 2022: 1.05 | Q2 2022: 1.07 (EURCHF)

The last two months have witnessed a substantive grind lower in EUR/CHF. Across that period, we have seen the CHF gain more than 4%. The broad-based CHF gain, against an increasingly beleaguered EUR, has seen the cross trade below 1.04 for the first time since mid-2015. Gains in the CHF came despite the fact that leveraged players moved substantially short of the CHF into early November.

Previously, the SNB have acted to contain CHF gains in order to preclude disinflationary pressures while also maintaining competitiveness with the EUR. However, as November inflation reached 1.5%, we have not seen higher prices since 2008, this likely supported a reduction in intervention flows.

Should the SNB encounter similar inflationary tendencies as that expected by the ECB, namely long-run price pressures are expected to be contained, not least as second-round wage effects remain limited, this underlines the scope for renewed intervention activity, to preclude a return of disinflationary tendencies. Indeed, in the wake of the most recent sight deposit data revealing the fastest weekly gain since May, this points towards the monetary authorities becoming increasingly mindful of the negative effects of recent CHF strength.

Of course, the arrival of the omicron variant provides a new variable to throw into the CHF mix; this comes as the currency remains a primary risk-off beneficiary. Omicron risks notwithstanding, SNB inertia, in line with the ECB, allied to an acceleration in intervention, points towards potential underperformance against ongoing USD impetus into 2022.

SEK

Jeremy Stretch

Markets underestimating Riksbank action

Q1 2022: 10.00 | Q2 2022: 9.80 (EURSEK)

After strong gains in the SEK into the start of November, the pro-cyclical currency has suffered significant collateral damage in recent weeks, even if the lack of a commodity price dynamic has seen the currency outperform the NOK. Although we have recently seen the SEK depreciate versus the G3, Swedish underlying domestic fundamentals remain supportive. While the latest economic tendency survey continued to correct from the all-time high seen back in July, forward-looking macro survey data, such as manufacturing and services PMI, remain encouraging.

We have also seen targeted inflation, CPIF, reach 3.6% in November, as combination of base effects and elevated electricity prices have it topping 3.5% for the first time since 2008. Although Riksbank Deputy Governor Breman suggests that there is "no clear tendency" for wider inflation pressures, the price spike does support the narrative of scaling back bond purchases in the year ahead. Despite the combination of supportive data and inflationary influences, the Riksbank continues to anticipate rates remaining at current levels, zero, through to H1 2024.

The paring back in global demand expectations in recent weeks has seen the market trim policy tightening expectations over the next twelve months by around 20bp. While the Riksbank continues to underline policy inertia, the market is now barely discounting one hike in the year ahead. In view of the supportive domestic dynamics, as the economy continues to avoid obvious spillover effects from global supply chain disruptions, we would continue to view such tightening expectations as appearing to be too benign. As a consequence, we anticipate a positive SEK outlook into 2022, under the assumption that the omicron wave doesn't derail the broader global recovery for the coming year as a whole.

Commodity FX
NOK

Jeremy Stretch

Norges Bank tightening to support NOK momentum ahead

Q1 2022: 9.85 | Q2 2022: 9.70 (EURNOK)

Despite the Norwegian government instituting its fourth round of restrictions in just two weeks, the Norges Bank looked through omicron-related risks to follow through with the second hike in this cycle. That 25bp move came despite a tightening in restrictions which include a ban on serving alcohol in bars and restaurants, a closing of gyms and swimming pools to most users, and stricter rules in schools.

The second policy adjustment, taking rates to 0.50%, comes as the central bank appears intent upon extending policy normalisation. Expect the Norges Bank to look to return the deposit rate to pre-pandemic levels at 1.50% prior to the end of 2023. Although the central bankers trimmed their 2022 GDP estimate by a full percentage point, to now stand at 3.5%, the Norges bank continues to maintain a similar rate profile as that assumed in September. In view of the residual strength of the recovery, elevated financial imbalances and rising inflation concerns, we would expect another 25bp tightening to come in March.

That would be consistent with its demonstrated willingness to look past near term omicron risks. The early arrival of the variant prompted a near 40bp retreat in one-year rate expectations from mid-November highs. The high beta commodity status of the currency underlines its susceptibility to headline risk. However, we would regard the correction in rate expectations as excessive. As a consequence, we would regard the NOK as remaining set to progressively advance, reversing the depreciation seen through the bulk of Q4.

AUD

Patrick Bennett

RBA outlook supports AUD recovery

Q1 2022: 0.73 | Q2 2022: 0.74 (AUDUSD)

The Australian dollar has rebounded from a test of major support vs the USD at 0.7000, and while in a mode of correction to the decline of the last month, looks set to extend somewhat higher. A confluence of recent factors supports the near-term positive outlook. They include a more positive economic outlook from the RBA, and from China, a RRR cut, easing of property curbs, and strong trade data.

The trend of AUD/USD over the last six months has been for tests of support, as a stronger USD, divergence in the outlook for monetary policy normalisation between the Fed and the RBA, and concerns over supply chain disruptions, particularly as they relate to demand from China, have all had impacts. The stronger USD continues to be an influence, and the present move is seen in the form of consolidation, as other factors have turned somewhat in favour of the AUD.

The RBA left policy unchanged in December, as widely expected. In the accompanying statement, RBA said the economy is expected to return to its pre-Delta path in 1H 2022. That is a more upbeat view than previous messaging that talked of 2H 2022. The positive shift was heralded by a less negative 3Q GDP result than had been expected.

Though market pricing for RBA hikes is still rich to RBA guidance on when inflation will sustainably reach target, and the lift off timing between the RBA and FOMC is uneven, the implied cash rates between Australia and the US in 1-years' time are widening in favour of AUD. The latest levels are around 97bps vs 73bps. That widening has been supportive of the recovery in AUD/USD.

NZD

Patrick Bennett

RBNZ hikes vs. activity headwinds

Q1 2022: 0.70 | Q2 2022: 0.71 (NZDUSD)

The RBNZ was amongst the first major central banks to begin monetary policy normalisation. Despite some initial support for the NZD, the outlook for the currency is now caught between support from higher yields and concerns that tighter policy will eventually be a headwind to activity. A strong USD overall and bouts of risk aversion have seen the NZD underperform in recent weeks.

We expect the RBNZ to continue hiking the cash rate through until 2023, based on the latest bank projections. Rate differentials should therefore be one factor in favour of the currency. Though as previously noted, 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 so far been strong and is expected to remain so into 1H 2022. That has been underpinned to-date by fiscal and monetary support, while strong external demand has lifted the terms-of-trade to a record. The question that now arises however, is when the monetary tightening becomes restrictive and activity slows. That looks to be a challenge for 2H 2022.

Until that time, the expanding differential between New Zealand and other major economy yields, will support

NZD gains. We recommend being buyers of weakness in NZD vs EUR and JPY. NZD support against the USD is expected in the early months of the year as the initial pace of RBNZ hikes outpaces the Fed.

ZAR

Jeremy Stretch

ZAR negativity compounded by omicron tourism impact

Q1 2022: 16.25 | Q2 2022: 16.25 (USDZAR)

The ZAR remains by far the worst-performing major over the last three months. The currency has depreciated by more than 11% versus the USD as foreign investors abandoned domestic bonds over the period. An aggressive uptick in inflationary pressures across the year, with CPI climbing from 2.9% back in February to 5.0% in October, prompted the SARB to follow many other emerging market nations in hiking rates.

After hiking to 3.75% at the last meeting, rates look set to advance by a further 25bp in Q1. Indeed, in the wake of the central bank revising up the inflation profile, the trend of policy tightening risks extending towards 5.0% in the next 12 months, further compromising the recovery narrative in the process.

Even ahead of the announcement of the omicron variant, economic activity looked set to moderate to below 2% in 2022 and 2023. With the key travel season appearing to be materially compromised by travel restrictions, an extension in ZAR negativity is likely. Although the currency may longer be burdened by a substantive current account shortfall, and therefore not as dependant on hot money inflows, the prospect for rising US rates, impacting those with USD liabilities, allied to the USD likely generating a degree of safe-haven status, favours ongoing ZAR negativity.

Real money investors extended net ZAR longs to near two-month highs ahead of the arrival of the omicron variant. We would expect this positional skew to be at risk in the absence of an early resumption of overseas travel. However, the backdrop of low levels of vaccination, well below 30%, suggests that another season of tourist dollars looks set to be missed, encouraging near-term USD ZAR upside.

LATAM FX
MXN

Luis Hurtado

Banxico accelerates pace of rate increases, but…

Q1 2022: 21.0 | Q2 2022: 22.0 (USDMXN)

In the weeks prior to December 16th announcement, we recognized the increasing odds of a hawkish surprise. And it materialized, with the announcement of a 50 bps rate increase, contrary to market consensus and our base forecast for a 25 bps hike. However, it is worth noting that the decision was not unanimous, with one member (Gerardo Esquivel) voting in favour of a 25 bps hike.

We do not expect Banxico's increased hawkish tone to last for too long and suggest tactical USD/MXN longs at 20.80, with a 21.40 target and 20.50 stop. Three points support this view.

First, the nomination of Victoria Rodriguez instead of Arturo Herrera (former Minister of Finance) for the top role at the central bank signals the current administrations greater influence on Banxico. Hence, we find it difficult to believe that the 50 bps rate increase will be maintained for a prolonged period. This view is backstopped by the current division among the board members, the new and likely dovish appointment at Banxico's board, and the negative surprises in recent economic activity numbers.

Second, we have seen more frequent and sudden USD/MXN spikes following negative global market news. The larger-than-expected inflationary pressures in the US are likely to keep the MXN on the defensive as the market assesses the timing and magnitude of the Fed's monetary policy tightening.

Third, although Mexico's fiscal deterioration has not been as pronounced as that in the rest of the region following the onset of COVID-19, continuous support to Pemex through lower taxes and debt payments will likely reignite credit rating concerns as growth decelerates. We expect this situation to gain greater relevance in the second half of 2022, and would not rule out negative credit actions. Moreover, the market should remain alert to any signs of price control to battle the recent increase in inflation and inflation expectations, a situation we can't discount given the populist tendencies of the current government.

BRL

Luis Hurtado

BCB Increases Selic rate by 150bps and keeps aggressive monetary tightening cycle

Q1 2022: 5.70 | Q2 2022: 5.70 (USDBRL)

In an unanimous decision, the Banco Central do Brasil increased the Selic rate by 150 bps to 9.25%, in line with market expectations and our forecast. Despite inflation being subject to persistent upward pressure, the decision to maintain rather than increase the magnitude of rate increases comes in response to the deceleration of economic activity in recent months. Moreover, although fiscal risks have heightened considerably, it appears that an alternative worse than the spending cap tweaks has been avoided, for now. Looking ahead, the central bank signaled another 150 bps in February and did not rule out further adjustments. However, the deceleration of economic activity growth suggests that the bar for larger rate hikes is now higher. Hence, we expect the BCB to maintain the current pace of rate increases and the Selic rate to reach 11.25% by the end of Q1 2022.

Despite the aggressive BCB monetary tightening cycle, we do not see enough room for a sustained BRL rally in the short term. The probability for an acceleration in the current pace of rate increases has diminished as economic activity decelerates. Moreover, the constitutional amendment to free up more space in the 2022 budget, although avoiding a more damaging alternative, has set a concerning precedent, opening the door for further expenses outside the spending cap down the road. We expect political noise to intensify ahead of the October presidential election, further delaying discussions of important reforms (i.e., administrative and tax) in congress and bringing to the table populist measures such as changes to Petrobras' fuel pricing policy. Hence, we maintain our bias towards buying USD/BRL dips at 5.50 with a 5.30 stop loss and a 5.90 target.

CLP

Luis Hurtado

BCCh increases overnight rate 125bps and signals more to come

Q1 2022: 780 | Q2 2022: 780 (USDCLP)

On December 14, the BCCh increased the overnight rate by 125 bps to 4.0% in an unanimous decision. In line with market consensus, the BCCh maintained a hawkish tone and stated it will raise the rate above neutral in the short term, confirming our expectations of another 125 bps rate increase in the next meeting. As in previous rate announcements, the CB highlighted high inflation (370bps above target), above target inflation expectations and larger-than-expected growth as the main reasons behind this decision.

Looking at the peso, political uncertainty in Chile has kept investors wary of loading on short USD/CLP positions despite the aggressive monetary tightening cycle. Although we expect this uncertain situation to persist until the end of 2021, we do not expect radical ideas from either candidate to be supported in an evenly divided congress. Hence, we expect the dissipation of electoral uncertainties and an even distribution of seats between left and right political parties to bode well for the CLP into early 2022, as do high copper prices and BCCH's front-loading of the monetary tightening cycle. We favour tactical short USD/CLP positions from 840 back to the 800-810 range.

COP

Luis Hurtado

Banrep to accelerate tightening cycle

Q1 2022: 4200 | Q2 2022: 4100 (USDCOP)

Banrep increased the overnight rate by 50 bps to 3.00% in December, in line with market consensus and our forecast. Banrep once again left the door open for more and larger rate increases as inflationary pressures remained in place and both core and headline inflation are above target. Moreover, the central bank revised its inflation forecast upwards. Hence, we expect Banrep to accelerate the pace of rate increases to 75bps in Q1 2022.

Looking at USD/COP, although we recognize that the global supply shock and recent upward surprises to headline inflation suggest a front-loading of the tightening cycle, current political dynamics should continue to contain very hawkish surprises in the short term. Note that, unlike most central banks in the region, the Minister of Finance has a vote on Banrep’s board, a fact that also supports a gradual approach by the central bank, especially in an election year. Notwithstanding short-lived rebounds in the COP driven by today’s hawkish tone, and takeover bids for foodmaker Nutresa and financial conglomerate Grupo Sura (potentially amounting to over US$2.5bln), we expect market expectations of a move to the left – as Gustavo Petro (leftist candidate) maintains a wide lead in recent polls – to return USD/COP to its all-time highs as Colombia's election cycle kicks in next quarter.

Asia FX
CNY

Patrick Bennett

Appreciation continues, but a fast pace is resisted

Q1 2022: 6.30 | Q2 2022: 6.25 (USDCNY)

Despite facing economic headwinds from lingering COVID and related issues, the Chinese yuan has been the strongest major currency through 2021. We expect further appreciation in 2022.

Outperformance is supported by a combination of inward portfolio demand for Chinese assets, pro-active monetary policy settings that have been able to arrest a loss of economic momentum, and allowing of modest currency appreciation in order to counter the impact of higher input and import prices, particularly those of industrial metal and energy commodities. One note of caution is that current appreciation is running ahead of interest rate differentials. Another is the recent hike in FX RRR, the second such move this year.

Overall asset demand has also been bolstered by a reduction in perceived premium to invest in China, which has previously been impacted by a lack of economic clarity and geopolitical tensions. Presidents Xi and Biden having started dialogue through the recent virtual summit, calming perceptions of the nations heading toward conflict, and is reason for encouragement that the premium can be reduced. Even if that does not deny that tensions at some level will almost certainly be a feature for some time to come.

Chinese monetary policy has been kept ‘basically stable’, though has still been set to be economically supportive throughout the last year. PBoC cut the RRR by 50bps in July and again in December, while liquidity is managed through open market operations. We expect the same approach in 2022, with the mantra of ‘targeted support’ to be prominent. That will mean targeted lending instructions and a possible further RRR cut for banks to support small and medium sized businesses.

There is always a risk that the pace of currency gains will raise ire of authorities. But an ongoing strong trade performance, and a widening current account surplus support appreciation, and suggest on these factors, the relative hands-off approach to the currency can continue. The FX RRR hike is viewed as a mild response to the pace of appreciation, not against appreciation itself.

CIBC Capital Markets

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FICC Strategy

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Canadian Government Credit

Tom Bognar, CFA
+1 416 956-6032
tom.bognar@cibc.com

Rates

Ian Pollick
+1 416 594-7057
ian.pollick@cibc.com

Foreign Exchange

Jeremy Stretch
+44 0 207 234-7232
jeremy.stretch@cibc.com

Bipan Rai
+1 416 594-7925
bipan.rai@cibc.com

Patrick Bennett
+852 3907-6351
patrick.bennett@cibc.com

Foreign Exchange & Rates

Sarah Ying
+1 416 594-8302
sarah.ying@cibc.com

Canadian Corporate IG Credit

Adam Bulley
+1 416 594-8510
adam.bulley@cibc.com

Growth Markets (LATAM & Caribbean)

Luis Hurtado
+1 416 594-8284
luis.hurtado@cibc.com

Economics

economics.cibccm.com

Avery Shenfeld
+1 416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
+1 416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
+1 416 956-3219
andrew.grantham@cibc.com

Royce Mendes
+1 416 594-7354
royce.mendes@cibc.com

Katherine Judge
+1 416 956-6527
katherine.judge@cibc.com

Institutional Equity Research

Equity Portfolio Strategy

Ian de Verteuil
+1 416 594-7462
ian.deverteuil@cibc.com

Shaz Merwat
+1 416 956-6428
shaz.merwat@cibc.com

See separate disclaimer.

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