CIBC

CIBC CAPITAL MARKETS

Economics and FICC Strategy

MONTHLY FX OUTLOOK

June 23, 2022

USD strength extended as Fed races ahead with tightening

Currency	What's changed
USD	Fed's hawkish tilt to extend the USD's fortunes, but that will fade into 2023 as other major central banks press on with normalizing policy.
CAD	With the Fed's terminal rate surpassing the Bank of Canada's, we've weakened our forecast for the loonie into 2023.
EUR	ECB policy gradualism suggests that euro bulls will have to wait until 2023 for an appreciation.
GBP	The BoE prioritizing growth over containing inflation suggests GBP downside, compounded by political risks, including a potential trade spat with the EU.
JPY	With the BoJ signalling that 10-year JGB yields will continue to be capped by yield curve control, UST-JGB spreads point towards USD/JPY remaining elevated.
Commodity FX	A stronger USD and concerns over domestic economic activity under the influence of hawkish central bank messaging have weighed on both AUD and NZD. While we have doubts that the degree of tightening priced will actually be delivered, the near-term influences remain negative.
LATAM FX	Equities rout and hawkish Fed push USD/LATAM pairs higher, while expectations of an extension of the tightening cycle in Latin America have increased.
FX Asia	Recent data suggest that the worst has passed for China's economy, and relative currency stability is expected as policy support measures continue.

Currency outlook

End of period:	June 23, 2022	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
USD / CAD	1.30	1.29	1.31	1.33	1.33	1.31	1.31
EUR / USD	1.05	1.04	1.05	1.07	1.08	1.10	1.10
USD / JPY	135	135	132	127	126	125	122
GBP / USD	1.23	1.18	1.19	1.21	1.22	1.25	1.26
USD / CHF	0.96	0.96	0.96	0.95	0.95	0.95	0.96
USD / SEK	10.19	10.38	10.10	9.77	9.63	9.36	9.27
AUD / USD	0.69	0.68	0.67	0.68	0.69	0.70	0.71
NZD / USD	0.63	0.62	0.61	0.62	0.63	0.64	0.65
USD / NOK	9.98	9.81	9.52	9.21	8.98	8.73	8.64
USD / ZAR	16.01	16.25	16.00	15.75	15.50	15.25	15.00
USD / BRL	5.18	6.00	5.70	5.90	5.70	5.50	5.30
USD / MXN	20.1	21.5	21.5	21.0	21.5	21.3	21.5
USD / COP	4042	4000	4000	3900	3800	3800	3800
USD / CLP	891	800	800	790	780	780	780
USD / CNY	6.71	6.70	6.60	6.65	6.60	6.55	6.55
USD / KRW	1302	1295	1185	1180	1175	1175	1165
USD / INR	78.3	78.0	77.5	77.0	76.5	76.0	76.0
USD / SGD	1.39	1.39	1.38	1.38	1.37	1.37	1.37
USD / TWD	29.8	29.7	29.5	29.4	29.4	29.3	29.2
USD / MYR	4.41	4.40	4.35	4.30	4.25	4.25	4.20
USD / IDR	14838	14700	14600	14550	14500	14400	14300

Other crosses

End of period:	June 23, 2022	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
CADJPY	104.2	104.7	100.8	95.5	94.7	95.4	93.1
AUDCAD	0.90	0.88	0.88	0.90	0.92	0.91	0.92
GBPCAD	1.59	1.52	1.56	1.61	1.62	1.64	1.65
EURCAD	1.36	1.34	1.38	1.42	1.44	1.44	1.44
EURJPY	142	140	139	136	136	138	134
EURGBP	0.86	0.88	0.88	0.88	0.89	0.88	0.87
EURCHF	1.01	1.00	1.01	1.02	1.03	1.05	1.06
EURSEK	10.71	10.80	10.61	10.45	10.40	10.30	10.20
EURNOK	10.49	10.20	10.00	9.85	9.70	9.60	9.50

Key indicators – Latest data point

End of period:	Quarterly real GDP (y/y %)	CPI (y/y %)	Current acct (% of GDP)	Central bank rate (%)
US	3.5	8.6	-3.6	1.625
Canada	2.9	7.7	0.7	1.500
Eurozone	5.4	8.1	1.8	-0.500
Japan	0.4	2.5	2.3	-0.100
UK	8.7	9.1	-2.6	1.250
Switzerland	4.5	2.9	9.3	-0.250
Sweden	3.1	7.3	4.9	0.250
Australia	3.3	5.2	5.2	0.850
New Zealand	0.4	6.9	-6.5	2.000
Norway	4.8	5.7	19.5	1.250
South Africa	2.9	6.5	1.9	4.750
Brazil	1.7	11.7	-1.6	13.250
Mexico	1.8	7.7	-0.2	7.000
Colombia	8.5	9.1	-6.3	6.000
Chile	7.2	11.5	-7.3	9.000
China	4.8	2.1	1.8	2.100
South Korea	3.0	5.4	4.7	1.750
India	4.1	7.0	-1.1	4.900
Singapore	3.7	5.4	19.8	n/a
Taiwan	3.1	3.4	15.2	1.500
Malaysia	5.0	2.3	2.8	2.000
Indonesia	5.0	3.6	0.4	3.500

CAD

Katherine Judge and Avery Shenfeld

CAD profile softer as Fed races to higher terminal rate

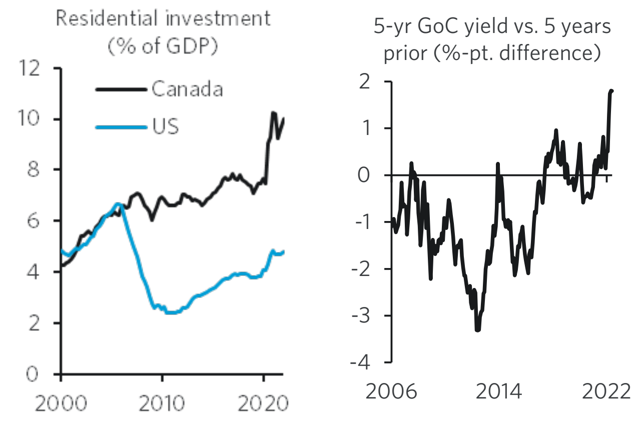
Q3 2022: 1.29 | Q4 2022: 1.31 (USDCAD)

Whatever positives a rebound in oil prices and a more hawkish Bank of Canada might have generated for the loonie haven't been enough to prevent it from a modest depreciation in recent weeks. That extended the trend of the CAD largely following the pack in movements against the broad greenback, which had received a safe-haven bid on the war in Ukraine, and more recently on the flight to safety as risk assets deteriorated as the Fed accelerated its rate hiking cycle. A likely 75 bp hike by the Bank of Canada in July, and the potential for another move of that magnitude in September if we don't see enough of an inflation deceleration by then, should be aggressive enough to allow USDCAD to remain around current levels over the next three months.

Thereafter, however, contrary to market expectations, the BoC is unlikely to send Canada's overnight rate beyond the Fed's destination of 3.25%. Canada's debt-burdened households and mortgage renewals will see rate hikes weigh more on discretionary consumer spending in Canada (Chart). That points to a slightly lower terminal rate for the BoC overnight rate, although we're leaning towards a 3% peak rather than our prior 2.75% after the May inflation data. Markets appear to be overpricing both BoC and Fed tightening this year, but comparatively more for the BoC, and that recalibration will lead the CAD to end the year weaker, with USDCAD expected to reach 1.31 by then.

In 2023, the loonie could weaken further on a global slowdown in growth as interest rate hikes take a toll on activity, which will weigh on commodity prices and dent nominal exports for Canadian natural resource producers. Moreover, the ongoing widening in the travel services trade deficit as the pandemic fades will add to pressure on the loonie, particularly in the winter months when the travel services deficit is at its largest share of GDP when not adjusted for seasonality. All told, look for USDCAD to reach 1.33 in early 2023, before recouping some of that ground further into the year as the USD loses favour globally.

Chart 1: Canada's higher exposure to housing slowdown (l), as mortgages come up for renewal at higher rates (r), will limit BoC terminal rate



Source: Bloomberg, CIBC

USD

Bipan Rai

Hawkish Fed gives the greenback wings for now

Q3 2022: 105.6 | Q4 2022: 106.3 (DXY)

Last week, the Fed took a big step forward in taming inflationary pressures, with a historic 75bps rate hike. While Chair Powell was less committal on the possibility of another 75bps hike in July, we still see the risks tilted in that direction. For one, financial conditions in the US are still much too loose relative to where they need to be, and most indicators still point to a tight US labor market. On top of that, the real Fed funds rate is still negative, even when discounted by a longer term inflation target of 2%, a clear indication that more work needs to be done in order to get inflation levels back to target and interest rates above neutral settings.

The Fed understands this as well. If you paid close attention to Chair Powell's press conference, you noticed that the messaging on how much tightening is needed has changed in a meaningful way. Instead of tightening policy to neutral, it's now all about getting policy to restrictive levels by the end of this year, and saying that loudly enough to try to impact inflation expectations. We ultimately see slowing growth and a turn in inflation as convincing the Fed to back away from what its most hawkish members are now advocating, paving the way towards a softer greenback in 2023. But that's not going to be apparent in the next few months, leaving the near term risks still tilted towards the USD retaining or even building further on its recent gains.

EUR

Jeremy Stretch

EUR: ECB tightening is imminent

Q3 2022: 1.04 | Q4 2022: 1.05 (EURUSD)

The June ECB underlined a move away from unconventional policy as the bank detailed an end to asset purchases from 1 July. However, policy sequencing mandated that asset purchases had to end prior to any rate adjustment. Consequently, despite HICP being at a record 8.1% and the ECB forecasting an inflation overshoot for the first time, ECB sequencing precluded the bank from hiking. That being said, the bank has clearly committed to policy gradualism, as they look to hike the deposit rate for the first time since 2014, by 25bps.

ECB policy gradualism is akin to 25bps adjustments. However, we note that the ECB statement stated that a data-dependent ECB can deviate from a ‘‘gradual but sustained path of further increases’’ should the medium-term inflation outlook deteriorate. Under such circumstances, ‘‘a larger increment will be appropriate.’’ The reference suggests that absent a material correction in inflation and inflation expectations, we should expect 50bps in September.

Such a move will result in a positive deposit rate for the first time in eight years. This would favour long-term FX diversification appetite and residual EUR support. However, as the ECB looks to tighten policy, fragmentation risk, namely yields in peripheral markets blowing out, risking debt sustainability, remain a concern.

Indeed, the ECB was so spooked by the blowout in Italian interest rates versus those in Germany post the June ECB that the Governing Council convened an extraordinary meeting to underline preparations for a new crisis tool to prevent policy fragmentation. Fragmentation risks continue to be seen as a potential impediment to aggressive ECB policy adjustments. Should the ECB design a tool that precludes exponential peripheral spread widening, a more aggressive ECB reaction function would be possible. Avoidance of another round of debt concerns, allied to avoidance of fragmentation risks, will help limit near-term EUR downside against a USD which currently remains risk and rate supported. Over the medium run, expect diversification interest to sustain support EUR valuations.

JPY

Jeremy Stretch

BoJ Maintains yield curve control

Q3 2022: 135 | Q4 2022: 132 (USDJPY)

After a succession of central bank surprises and policy adjustments, including an unexpected SNB hike, isolating the BoJ, the bank maintained policy stability once again. The BoJ remains wedded to an easy stance and will not hesitate to take additional measures, if necessary. Moreover, the bank continues to underline that it expects short and long-term policy rates to remain at ‘‘present or lower levels.’’ That commitment is notable when combined with BoJ Governor Kuroda maintaining that he anticipates no obvious change in the strategy of limiting 10-year JGB yields, under the YCC regime, to 0.25%.

The BoJ remains intent on limiting JGB yields, while still leaving open the possibility, however remote, of easing policy still further. For some, the lack of action suggests that the BoJ is isolated and is out of step with other global central banks. An alternative scenario is that the lack of surprise points toward policy consistency. What is evident is that as global monetary policy paths continue to diverge, the perpetuation of yield curve control leaves the JPY as the policy shock absorber.

In that context, it was notable that the recent BoJ policy statement included a rare FX reference. The BoJ detailed that “It is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan’s economic activity and prices.” The currency reference underlines that the BoJ is not totally immune to JPY weakness. Although the monetary authorities are paying attention to the JPY, they are not necessarily signaling a lack of tolerance for JPY weakness, rather they are looking to avoid disorderly moves. As the BoJ signaled that 10-year JGB yields will continue to be capped UST-JGB spreads point towards USD/JPY remaining elevated.

GBP

Jeremy Stretch

BoE Still hiking, but risks undershooting expectations

Q3 2022: 1.18 | Q4 2022: 1.19 (GBPUSD)

The June BoE resulted in a fifth successive hike for the first time. The MPC stuck to policy incrementalism despite three external MPC members, Mann, Haskel and Saunders voting for an immediate 50bps for a second straight month. The market was initially disappointed by the modest 25bps hike, as the market was pricing in

40bps. However, a modest firming up of the policy language quickly encouraged the market to re-price UK rate expectations.

The addition of a reference to 'act forcefully,' encouraged the market to amplify year-end rate expectations. However, as the BoE discounted CPI in excess of 10% at the May meeting, which included updated forecasts, the upgrading of the language needs to be kept in context.

The May QIR assumed a slowing growth trajectory. The decline in April GDP was amplified by a reduction in health-related spending, due to the reduction in Covid testing. The downtrend in activity, influenced by collapsing consumer sentiment, underlines building macro headwinds. That being said, the BoE is not yet witnessing signs of overt labour market weakness. The BoE anticipates that labour market changes usually lag GDP by one to two quarters. As we expect negative growth in both Q2 and Q3, encouraging annual growth to tip into negative territory into 2023, this underlines labour market risks into next year.

Sliding consumer sentiment and spending, as real earnings head lower, will help squeeze demand-side inflationary pressures out of the system. Building macro headwinds suggest that the BoE will not be as aggressive as the market discounts. We expect a protracted policy pause post once rates reach 1.75% in September. As the growth versus inflation trade-off remains challenging, expect the bank to prioritize growth. This favours GBP downside, especially as ongoing political risks, including a potential trade spat with the EU, remains real.

CHF

Jeremy Stretch

SNB Switching tack

Q3 2022: 1.00 | Q4 2022: 1.01 (EURCHF)

Previously we had noted that the SNB viewed the uptrend in inflation as not warranting a rate hike. However, in the view of May CPI accelerating to 2.9%, and the three-year forecast horizon, (out to 2025 for the first time) witnessing prices above the 2% CPI threshold resulted in the SNB shocking the market. Not only did they hike rates for the first time since 2007 they adjusted by 0.50%, taking rates above those in the eurozone.

The central bank previously viewed the currency as highly valued, hence they have looked to cap levels versus the EUR in particular. The recent reduction in Swiss sight deposits underlined that the central bank was preparing to adjust its policy focus, albeit that failed to prepare the market for the aggressive reaction function. The SNB policy response underlines that the central bank has moved to prioritize its inflation mandate over the currency. That being said SNB Governor Jordan emphasized in the post-decision press briefing that the bank would be prepared to intervene if the CHF appreciated excessively.

That Swiss rates are now above those in the eurozone, (the ECB has pre-committed to a 25bps hike in July) underlines a short-term CHF yield advantage. This risks the Swiss Franc trading towards parity versus the EUR. While any such move would help limit imported inflationary dynamics it would test the SNB's potential pain threshold. Having unexpectedly hiked by 50bps now the market has priced in another 50bps by the end of Q3. While the bank is clearly intent on bearing down on price pressures, via monetary policy adjustment, real estate concerns need to be considered. The SNB has warned that real estate is at risk of an abrupt correction if rates rise too quickly. Such concerns may prove to limit policy tightening compared to market presumptions, a factor which alongside the threat of intervention may preclude EUR/CHF trading through parity.

SEK

Jeremy Stretch

Risk susceptibility to persist

Q3 2022: 10.80 | Q4 2022: 10.61 (EURSEK)

The high beta status of the SEK leaves it susceptible to global recession fears and inflation concerns. Hence in the wake of the material slide in risk assets over the last two months the Swedish unit has lost almost 6% versus the Greenback. The SEK slide reflects that the weekly inverse correlation between the SEK and the US VIX equity volatility index has advanced to 0.55, in the process exceeding the cyclical peak witnessed back in late 2011.

Beyond risk negativity widening economic differentials have tested the currency. Although both manufacturing and services PMI remain comfortably in expansionary territory on a 3m moving average basis the disconnect between the services and manufacturing is notable. Moreover, the economic tendency survey has dipped back into negative territory reaching levels not seen since August 2020. It is against a mixed backdrop that the market is not only discounting a 50bps rate hike at the 29 June policy meeting but it is pricing in more than 75bps for September.

Rising inflation may warrant increased Riksbank activism, CPIF reached 7.2% in May. Concurrent to the upswing in both headline and core CPI has been market-based inflation expectations continuing to oscillate around 3.50%, well above the 2% target threshold. Yet while CPI and market-based price expectations head higher there remains a notable disconnect with the

Prospera inflation expectations survey where the latter has merely climbed from 1.7% in Q4 2020 to 2.3% in Q2, above but still close to the price target. This suggests that market-rate expectations risk looking overdone.

Beyond questions regarding the inflation profile signs of a weakening in consumer confidence also question what is priced into the rates strip. Should the rolling over manufacturing sentiment be matched by the services sector this risks a reassessment of any presumed SEK rate support, which points towards negative SEK dynamics extending into Q3.

Commodity FX
NOK

Jeremy Stretch

Norges Bank continues tightening policy

Q3 2022: 10.20 | Q4 2022: 10.00 (EURNOK)

The Norges bank is set to extend a tightening profile that began back in September. The early move to tighten has prompted consideration of a graduated policy response. However, as targeted CPI reached 3.4% in May, price concerns are challenging a narrative of steady hikes into 2023. Expect tight labour markets to also impact central bank thinking. Unemployment claims peaked at 10.6% in March 2020. However, they have halved in the last year to now stand at 1.60% in May, narrowly above the 1.4% cyclical low from June 1987. The slide risks further wage pressures, underlining why markets point towards a terminal rate in excess of 2.75% by mid-2023.

The market views elevated price pressures and a tight labour market as justifying a policy acceleration. However, the recent central bank regional network survey painted a mixed backdrop hence it provides at least a degree of policy pause for thought. A tighter policy backdrop is expected to moderate growth trends, this comes in conjunction with ongoing goods sector shortages. However, we would note that despite such headwinds the economic surprise index remains near early January extremes.

Despite the fact that oil prices have moved higher across the quarter this has failed to preclude the NOK from proving the worst-performing major, the NOK has depreciated by near 11% versus the USD and more than 6% versus the single currency. Although the weekly inverse correlation between Brent Crude and EUR/NOK may have climbed to around 0.55, well above the long-term average, it seems that steady policy tightening, certainly compared to increasingly aggressive responses expected elsewhere, has impacted dragged on the NOK. Nevertheless, after a tough Q2, we would be wary of expecting the upcoming quarters to be quite as challenging.

AUD

Patrick Bennett

AUD: Tests of support expected

Q3 2022: 0.68 | Q4 2022: 0.67 (AUDUSD)

We have shifted markedly from a position of recommending buying the AUD into periods of weakness, to one where headwinds are building through inflation and hawkish central bank responses, pressuring the AUD towards further tests of support.

What has changed since April is that inflationary pressures have built substantially, to above both previous readings and forecast expectations. 1Q headline inflation climbed to 5.1% y/y from 3.5p and 4.6e, and the RBA's preferred measure, the trimmed mean CPI was recorded at 3.7% y/y vs 2.6p and 3.4e. The inflation result prompted the RBA to begin its normalisation process with a 25bps hike in May and follow with a 50bps move in June.

The newly hawkish push from the bank is taking place even as momentum in key sectors of the economy is appearing to wane, notably in housing and also reflected in soft consumer confidence. In fact the RBA has not begun a tightening cycle with consumer confidence already at such weak levels.

Due to the impact on activity from RBA tightening, we do not view hikes already delivered or subsequent moves as priced by the market, as being supportive for the AUD. Other central banks are moving in similar increments and are more advanced in their process, meaning interest rate differentials are less impacted. Though we note that on that measure, the AUD/USD today presents as slightly undervalued. But potential curbing of activity with an overly hawkish path from the RBA should see that differential narrow. On growth, downgrading of Australian forecasts will see the current positive differentials, and AUD support from those, eroded.

We are also concerned about the impact on global activity from sharply higher rates in a growing number of economies. The pro-cyclical and high-beta nature of the AUD have it at risk of being pressured as a result. Indeed, that has been a driver of AUD underperformance in recent weeks. We see it as an ongoing influence. We favour AUD/USD trading back toward its May low of 0.6830, with risk of deeper losses on indications of softer economic activity.

NZD

Patrick Bennett

NZD Losing ground on a softer economic outlook

Q3 2022: 0.62 | Q4 2022: 0.61 (NZDUSD)

The NZD is facing depreciation pressure sourced in a number of factors, including that from broad negative global risk sentiment. We see pressures continuing to build in coming weeks, and anticipate a retest of recent NZD/USD lows below 0.6200. A second successive 50bps hike in late May from the RBNZ, taking the rate to 2.00%, was as was widely expected, and though it did prompt an initial sharp rally in NZD/USD, the higher levels were not sustained. Nor do we believe they should be given the weak global outlook, and the implications to come for the domestic economy from the higher rates.

RBNZ messaging has been nothing other than hawkish. The bank sees rates above 3.25% this year and peaking at 3.95% next year vs their previous forecast of 3.35%. We previously forecast the OCR at 3.25% in 2Q of next year, but now revise that to be our end-of-year forecast, and add one more 25bps hike in 1Q for an expected 3.50% peak.

Already there has been evidence of slowing in consumer and business sentiment, and of a decline in house prices. Challenges to domestic activity from sharply higher rates are a negative that will be exacerbated by weak activity in China – New Zealand's largest trading partner, and by the outrun of higher rates and softer outlooks globally. In this environment, higher policy rates in New Zealand will not support the currency beyond present levels.

A key area of resistance in NZD/USD is between 0.6530 (January low) and 0.6576 (June high). While spot is held below this band, risk is for another test of the downside.

ZAR

Jeremy Stretch

EM Pressures as US rates spike

Q3 2022: 16.25 | Q4 2022: 16.00 (USDZAR)

The ZAR has proved something of a laggard amongst the majors during Q2, the currency has depreciated by nearly 9% versus the Greenback across the period. The depreciation comes as domestic inflationary pressures continue to accelerate. As prices are set to move well beyond the central bank's tolerance threshold, 3-6%, we can expect the 50bps hike from the May meeting to likely be replicated in July. Indeed as prices are likely to remain near the top of the inflation profile through 2022, the central bank now assumes an annual average of 5.9%, we can expect that rates are likely to be increased by 50bps at both the September and November meetings, resulting in the base rate reaching 6.25%.

Although additional monetary tightening will help contain inflation expectations the tighter monetary backdrop will amplify recent domestic headwinds relating to the impact of floods, reduced energy supply, and constraints on mineral production. The combination of a challenging near-term macro backdrop allied to foreign investors unwinding domestic bond holdings, as rising US rates raise concerns over foreign denominated borrowing, risks near-term ZAR headwinds. In the near term, we would also note a sign of caution in terms of the recent uptick in speculative ZAR holdings. Real money investors have materially advanced long ZAR holdings of late, indeed on the back of three gains in the last four snapshots net holdings have reached all-time extremes. With real rates set to remain negative, we would be wary of a position correction through the summer, encouraging modest near-term USD/ZAR upside risks.

LATAM FX
MXN

Luis Hurtado

Banxico gears up for a 75bps rate hike in June

Q3 2022: 21.5 | Q4 2022: 21.5 (USDMXN)

The latest minutes and recent board member comments show a tilt from the board to increase the pace of rate hikes in the short term, in line with our view of a 75 bps rate increase. However, we do not expect Banxico to maintain that pace or prolong the cycle of rate increases beyond this year, as currently priced in by the market. First, as suggested by the central bank, prices are likely to peak in Q2. Second, the measures announced by the government to contain inflation should start to feed into CPI in Q3, providing much-needed relief to the CB during the second half of Q3. And third, despite consensus building among most CB members about the need to act decisively in the next meeting against inflation, there are likely to be differences in opinions as to how long the central bank can maintain such a stance. Hence, although we revised our terminal overnight rate forecast to 9.0% to reflect the more aggressive stance by the Fed, our forecast remains significantly below 10.0%-10.25% overnight terminal rate currently priced in by the market.

Looking at the peso, USD/MXN flirted with breaking 20.70 as the market focused on US yields surge and the rout in equity markets. With a thin domestic agenda until the release of June bi-weekly numbers and Banxico's rate announcement on Thursday, we do not expect to see support to the peso from the local front. Moreover, as the market continues to focus on global growth prospects, and the decline in equity markets, we see

USD/MXN re-testing 20.70 and setting its sights on 21.00 on a break above said level.

BRL

Luis Hurtado

BCB plays it safe

Q3 2022: 6.00 | Q4 2022: 5.70 (USDBRL)

In an unanimous decision, the Banco Central do Brasil increased the Selic rate by 50 bps to 13.25% in line with market expectations and our forecast. However, the BCB signaled that it will implement a similar or smaller rate hike in August. We recognize that given current market dynamics (i.e. a more aggressive Fed tightening cycle, and lingering fiscal risks), the central bank is allowing some room to maneuver around the negative implications of its already large tightening cycle and external inflationary pressures, against our expectations of an end to the tightening cycle this month. Nonetheless, it is clear that the Selic rate is very near its peak – a situation not in line with the 100bps in additional rate hikes priced in by the market.

Note that although inflation remains high and external inflationary pressures persist, recent inflation data are starting to show signs of a peak. Moreover, congress approved the proposal to cap the ICMS state taxation on fuel, electricity, natural gas and telecommunications, and it is studying constitutional amendment measures to implement further fuel tax cuts

Since the start of 2022, accentuated by the increase in commodity prices, the carry has been the main factor behind the BRL's rally. However, despite the BCB giving itself some room to respond to the market pricing, a more aggressive tightening cycle in developed economies, and persistent external inflationary pressures, the central bank continues to signal the tightening cycle is near its end. Hence, we maintain our upward USD/BRL bias towards 5.20 in the short term.

CLP

Luis Hurtado

BCCh extends tightening cycle slightly

Q3 2022: 800 | Q4 2022: 800 (USDCLP)

The Central Bank of Chile increased the overnight rate by 75bps in June and signalled more to come, albeit at a slower pace. Despite the extension of the tightening cycle, and the initial outperformance of the CLP following the announcement, the peso succumbed to external pressures driven by a more aggressive Fed and the drop in equity markets, with USD/CLP approaching all-time highs again.

That said, the dissipation of risks related to the approval of the new constitution, the stronger institutional framework and a much better fiscal position relative to the rest of the region, together with a still hawkish BCCh are among the factors supporting our positive CLP view from current levels. Hence, we maintain our 800 USD/CLP forecast for the end of Q3.

COP

Luis Hurtado

Petro's victory should keep COP under pressure

Q3 2022: 4000 | Q4 2022: 4000 (USDCOP)

Despite the slight advantage in favour of Rodolfo Hernandez ahead of the runoff election on Sunday, leftist Gustavo Petro won Colombia's Presidential election with 50.44% of the votes. With thin liquidity due to the US and local holidays at the start of the week, we expect USD/COP to quickly jump above the 4100 mark and continue its path to the all-time high at 4237. Note that Petro's stance against new oil exploration (the country's main export) among other radical ideas had kept investors wary of his potential victory; nevertheless, this was not reflected in price action leading into Sunday's vote.

Going forward, we expect the market to focus on the Ministry of Finance appointment, and carefully analyze the checks and balances in place in congress as investors assess how feasible Petro's radical ideas are in the short term. We maintain our preference for buying USD/COP dips on any tactical pullbacks in the days ahead.

Asia FX
CNY

Patrick Bennett

CNH: Currency weakness may be complete

Q3 2022: 6.70 | Q4 2022: 6.60 (USDCNY)

When USD/CNH broke higher in April it was following a long period of CNH outperformance against an already strengthening USD. Chinese currency supports that were eroded to prompt the currency weakness included portfolio inflows and positive interest rate differentials. We were also concerned at weakening in the domestic economy and the consequent narrowing of growth differentials to other major economies.

Forward to now, and we see signs of the economy bottoming, and of equity market outperformance relative to global peers. We expect both factors have potential to encourage a return of portfolio inflow. We also draw attention to the now wide and still widening divergence between monetary policy settings in China and elsewhere. While a growing number of hawkish central banks are working to quell inflation by raising rates and slowing activity, the opposite is true of China, who are easing to support growth, and do not have a problem with inflation, CPI was last recorded at +2.1% y/y in May.

These developing factors combine to rebuild CNH support. Consequently we are shifting our outlook bias from one of risk of further weakness, to one where we are looking for opportunity to rebuild CNH longs.

With economic stimulus already delivered, combined with that filtering down through infrastructure projects, and still more support expected to come, the second half of the year looks set to produce a healthy rebound. The risk of reimposed lockdowns has not gone away. But in their absence, the Chinese growth outlook, both outright and relative to major peers is set to improve, and with it provide CNH support.

Basing Chinese and global equity indices to January 2020 or 2021, shows the Shanghai compositive index now matching the performance of the MSCI World Index, and closing ground to the S&P. The performance of the Shanghai index since early May is of notable outperformance of both MSCI World and the S&P. The timing of the beginning of the outperformance is near in line with the point of maximum weakness of the CNH. And coincides with timing of policy support for the economy.

In suggesting a shift in approach to seeking opportunity for CNH longs, we recommend selling USD/CNH ahead of 6.7870. However, we also note current market risk from slower global growth that can keep the USD stronger for somewhat longer. A change is expected and maximum weakness likely has been seen, but further evidence is sought on activity and flows.

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