CIBC

Economics and FICC Strategy

MONTHLY FX OUTLOOK

March 24, 2022

The denouement of the dollar dominance story

Currency	What's changed
USD	The USD's days of dominance are numbered as markets have moved to expect too much tightening from the Fed.
CAD	The loonie is stuck in neutral as the expected weakness resulting from the market's pricing in of Fed hikes was offset by the surprise rally in commodities.
EUR	While the ECB will trail the Fed, the potential for greater fiscal support in the Eurozone in H2 could support gains in the euro.
GBP	Markets look to be expecting too much tightening from the BoE this year, which will weigh on Sterling ahead as markets recalibrate.
JPY	Despite the BoJ being a policy laggard, an unwinding of the aggressive Fed tightening priced in could cause the yen to retrace lost ground ahead.
Commodity FX	RBNZ continues its hawkish tone, while the RBA continues to express capacity for patience before beginning to raise rates.
LATAM FX	Commodities rally is supporting LATAM currencies, but local risks remain.
FX Asia	Profit taking on previous portfolio inflows and narrower interest rate differentials vs. other majors are a potential headwind to further yuan appreciation.

Currency outlook

End of period:	Mar. 24/22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
USD / CAD	1.25	1.26	1.27	1.28	1.28	1.29	1.29	1.29
EUR / USD	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD / JPY	122	118	118	116	115	114	112	110
GBP / USD	1.32	1.30	1.31	1.31	1.33	1.34	1.35	1.36
USD / CHF	0.93	0.95	0.96	0.96	0.96	0.96	0.97	0.98
USD / SEK	9.40	9.27	9.01	8.75	8.54	8.42	8.39	8.36
AUD / USD	0.75	0.75	0.77	0.79	0.80	0.81	0.81	0.81
NZD / USD	0.70	0.70	0.71	0.72	0.73	0.73	0.74	0.74
USD / NOK	8.65	8.86	8.69	8.53	8.36	8.25	8.13	8.06
USD / ZAR	14.54	16.00	15.80	15.50	15.25	15.10	14.85	14.50
USD / BRL	4.82	5.70	6.00	5.70	5.90	5.70	5.50	5.30
USD / MXN	20.1	22.0	22.0	21.5	21.0	21.5	21.3	21.5
USD / COP	3792	4100	4000	4000	3900	3800	3800	3800
USD / CLP	788	780	800	800	790	780	780	780
USD / CNY	6.37	6.25	6.20	6.15	6.10	6.05	6.00	5.95
USD / KRW	1219	1200	1190	1180	1170	1165	1160	1155
USD / INR	76.4	76.0	75.0	74.5	74.0	73.5	73.0	72.0
USD / SGD	1.36	1.35	1.34	1.33	1.32	1.32	1.31	1.31
USD / TWD	28.6	28.0	27.7	27.4	27.1	26.9	26.7	26.5
USD / MYR	4.23	4.15	4.10	4.05	4.00	3.90	3.85	3.80
USD / IDR	14352	14300	14250	14200	14150	14100	14100	13950

Other crosses

End of period:	Mar. 24/22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23
CADJPY	97.4	93.7	92.9	91.0	89.8	88.4	86.8	85.3
AUDCAD	0.94	0.95	0.98	1.00	1.02	1.04	1.04	1.04
GBPCAD	1.65	1.64	1.66	1.67	1.70	1.73	1.74	1.75
EURCAD	1.38	1.39	1.41	1.43	1.45	1.47	1.48	1.50
EURJPY	134	130	131	130	130	130	129	128
EURGBP	0.83	0.85	0.85	0.85	0.85	0.85	0.85	0.85
EURCHF	1.02	1.05	1.07	1.08	1.08	1.09	1.12	1.14
EURSEK	10.34	10.20	10.00	9.80	9.65	9.60	9.65	9.70
EURNOK	9.52	9.75	9.65	9.55	9.45	9.41	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	5.7	7.9	-3.7	0.375
Canada	3.3	5.7	-0.1	0.500
Eurozone	4.6	5.9	2.6	0.000
Japan	0.4	0.9	2.9	-0.100
UK	6.5	5.5	-3.3	0.750
Switzerland	3.7	2.2	4.6	-0.750
Sweden	5.2	4.3	5.5	0.000
Australia	4.2	3.5	3.6	0.100
New Zealand	3.1	5.9	-4.0	1.000
Norway	5.4	3.7	15.4	0.750
South Africa	1.7	5.7	3.7	4.250
Brazil	1.7	10.5	-1.7	11.750
Mexico	1.1	7.3	-0.2	6.000
Colombia	10.8	8.0	-5.7	4.000
Chile	12.0	7.8	-6.4	5.500
China	4.0	0.9	1.8	2.100
South Korea	4.2	3.7	5.1	1.250
India	5.4	6.0	-0.4	4.000
Singapore	6.1	4.0	18.0	n/a
Taiwan	4.9	2.4	15.0	1.375
Malaysia	3.6	2.3	3.5	1.750
Indonesia	5.0	2.0	0.3	3.500

CAD

Katherine Judge and Avery Shenfeld

Loonie stuck in neutral as aggressive Fed pricing outweighed by commodities rally

Q2 2022: 1.26 | Q3 2022: 1.27 (USDCAD)

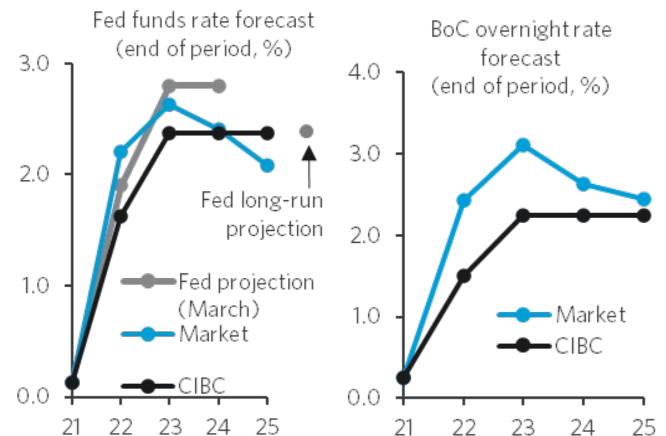
Our previous call for CAD weakness on the market moving to price in a more aggressive Fed tightening path was offset by the commodity price rally on the war in Ukraine, leaving the CAD trading within the range observed since last November. And it looks like a bit of a yawner for the Canadian dollar ahead, as the various forces steering it could roughly balance out.

In terms of rate hike expectations, markets are pricing in a reasonable story for the resting path for short term rates in both countries several years out, but likely a bit too much of a move in 2022 (Chart 1). If high oil prices dent real consumption growth this spring, and further Covid waves (as we've seen in Europe) create at least some delays in getting a complete recovery for services, both central banks will have reason to be careful about how quickly they tighten policy. As well, the BoC, and likely after May, the Fed, will be using quantitative tightening as an additional tool to reduce monetary stimulus, thereby relieving some of the burden on overnight rate hikes.

The BoC looks to hike by 25 bps in April, while the Fed, facing greater inflation pressures and a desire to make more of a statement, will likely deliver a 50 bps hike at its next meeting. That might weaken the loonie a touch, but over the rest of the year the two central banks will be moving in lock step. A more stretched out rate hike cycle from both relative to market expectations therefore won't be a story for the CAD.

If the world can squeeze out a bit more oil supply from non-Russian sources, and Russia's own output isn't fully cut off, crude prices could end the year softer. That could be enough to weaken the loonie a bit in 2023, but not much. The impact should be more modest than what's been seen in past decades, when oil industry capital spending in Canada was much more responsive to price swings. With oil less of a factor in driving Canadian economic growth swings, it plays a smaller role in setting Canadian-US interest rate spreads, resulting in a weaker correlation between crude and the CAD. Moreover, as oil corrects, pulling in the other direction will be a generally weaker USD against other majors next year, which tends to help the Canadian dollar hold ground.

Chart 1: Markets expecting too much from the Fed and BoC this year



Source: Bloomberg, CIBC

USD

Bipan Rai

"Peak hawkishness" portends USD softening

Q2 2022: 100.4 | Q3 2022: 99.8 (DXY)

If you were looking for a “tweet”-length summary of the last FOMC, it’s this: the Fed is now very concerned with the acceleration in inflation and is saying it's full-steam ahead on tightening. Gone are the days where the rise in consumer prices was explained away as "transitory". Instead, the Fed is bent on getting rates back towards more neutral settings, and assuring everyone that the economy is strong enough to withstand less accommodation.

For the USD, the more relevant takeaway from the projections was that the median dot for 2022 was revised upwards to indicate a total of seven hikes for this year. Still, that just had the Fed catching up to what the market was already pricing, and the USD has done little since the FOMC as a result. The big risk now for USD bulls is that we’re close to ‘peak hawkishness’ in terms of market pricing for the Fed. That skews the balance of risks to the USD to the downside for the latter part of the year, although DXY is still at loftier levels than we thought two months ago due to the safe haven bid from the war in Ukraine.

As the Fed progresses on its path to hike rates and shrink its balance sheet via QT, investors should keep close tabs on the deceleration in inflation and growth, and the potential for a Covid comeback, which would lend merit to our call for a more moderate dose of 150bps from the Fed this year, including the March hike. Currency markets will be especially sensitive to any shift in tone from Fed speakers should that be the case.

EUR

Jeremy Stretch

Euro to be propped up by potential fiscal support in H2

Q2 2022: 1.10 | Q3 2022: 1.11 (EURUSD)

Despite the eurozone being the area that is the most economically exposed to the war in Ukraine, the ECB has become increasingly hawkish of late. Although ECB President Lagarde may continue to stress that the ECB is merely normalizing policy and not tightening it, the faster pace of tapering against an increasingly exaggerated near-term HICP profile, underlines that the hawks are in control of ECB policy.

Trade links suggest that western Europe has significant economic vulnerabilities to the current conflict and a renewed cold war. German auto manufacturing has already proven compromised. In terms of energy prices, both security of supply and the rising cost of energy for energy-intensive German manufacturing, leave the zone's largest economy exposed.

Although the ECB materially revised up its inflation expectations for both 2022 and 2023 at its recent meeting, the revision for 2024 anticipated prices remaining below the 2% threshold. Concurrent to the upward HICP revision, the bank revised down growth assumptions. The downward revision for 2022, from 4.2% in December to 3.7%, looks potentially too modest. As a result, we expect growth risks to remain biased to the downside.

Regarding the HICP outlook, President Lagarde has reiterated that long-term inflation expectations have re-anchored in line with the 2% HICP target. Moreover, at the recent ECB Watchers Conference, Lagarde detailed that the ECB has looked to give itself extra space between ending asset purchases and hiking rates. While Governing Council hawks such as Knot may argue that two ECB rate hikes this year might be appropriate, we are unconvinced that the bank can or should hike as early as September. Extended ECB inertia allied to ongoing Ukraine-related uncertainties points towards risks of EUR/USD potentially retesting year-to-date lows at 1.0806.

But that should be a short-lived story. A patient ECB, and the potential for Euro area fiscal support, should support both economic conditions and the euro in the latter half of the year. A more tempered pace for the first year of Fed hikes relative to current market expectations should work in the same direction.

JPY

Jeremy Stretch

With markets too eager on Fed action, the yen could retrace lost ground ahead

Q2 2022: 118 | Q3 2022: 118 (USDJPY)

The JPY has depreciated markedly versus the USD since the Russian invasion into Ukraine. The slide has prompted Finance Minister Suzuki to suggest that he will continue to 'closely monitor' the impact of the weak JPY on the economy. Although the Finance Minister and the MoF, who control FX policy, speculate over the impact of the JPY slide, BoJ Governor Kuroda appears relaxed regarding the external value of the currency, as Kuroda has suggested he is happy to tolerate a cheaper JPY, provided it is driven by fundamentals.

In contrast to tightening that has commenced elsewhere, we expect the BoJ to maintain an ultra-easy policy stance into 2023. Although Governor Kuroda anticipates CPI testing the 2% target threshold into April, he does not expect inflation to remain at such levels, even factoring in the surge in energy prices and base effects from lower mobile phone fees dropping out from April. It's therefore unsurprising that the market is pricing only a 10% risk of a hike by the end of the year.

The combination of widening front-end spreads versus the USD, as the market prices in additional Fed hikes and BoJ inertia, has been favouring near-term USD/JPY gains. But we don't see that momentum extending over our forecast horizon, as the market may soon come to question the pace for US tightening, prompting a correction in recent spread widening. We therefore look for the yen to regain some its recent lost ground from here to year end.

GBP

Jeremy Stretch

Markets expecting too much from BoE

Q2 2022: 1.30 | Q3 2022: 1.31 (GBPUSD)

The March BoE meeting resulted in a 25bps hike to 0.75%, marking three straight hikes, something that hasn't been seen since the MPC's inception in 1997. However, in view of BoE warnings over rising policy risks and adjustments to policy language, we view the move as a dovish hike, and we maintain a bias towards Sterling weakness over the next few months. The Bank looks set to continue to tighten, and we expect another hike at the next meeting on 5 May. However, the prospects for a 50bps move have materially diminished as the Bank is increasingly mindful of external risks, while the lone March dissenter was not a vote for a

larger cut but rather one to hold off amidst broad market uncertainty.

Although the Bank has recognized the fact that Q1 activity levels and underlying inflation trends are higher than expected at the February MPC meeting, it appears less certain about the likelihood of additional action. The upcoming forecast update, in conjunction with the 5 May decision, will prove instrumental in determining whether the bank extends the run of back-to-back hikes to an all-time extreme at four.

The acknowledgment of the impact of falling real incomes underlines our view of a less aggressive rate profile than what is expected by the market. We assume that once rates hit 1.0%, triggering the QT threshold, the bank will be reluctant to rush towards additional tightening. Hence if we see 1.0% in May, we would expect a protracted pause thereafter, likely extending into 2023. Our expectation for a less aggressive policy profile than what's implied by the interest rate market underlines risks of GBP underperformance.

CHF

Jeremy Stretch

A more cautious SNB than markets expect will contain CHF strength

Q2 2022: 1.05 | Q3 2022: 1.07 (EURCHF)

The immediate aftermath of the outbreak of hostilities in Ukraine saw a material slide in EUR/CHF, resulting in a brief run below parity. Although trade-weighted CHF gains were less pronounced, underlining the slide was largely driven by the EUR, the CHF index spiked to levels not seen since 2015. Although EUR/CHF failed to close below the parity threshold, evidence of a material uptick in Swiss sight deposits in the week ending 11 March underlines that the SNB did not sit idly and allow the Swiss Franc to unilaterally gain. Although the CHF2.3bn weekly increase in total sight deposits was relatively modest, certainly compared to weekly increases in excess of CHF13bn in late April and early May 2020, the uptick was most pronounced in four months. The substantive increase does underline the fact that the SNB remains determined to preclude excessive CHF gains.

The SNB remains intent upon maintaining exports competitiveness. Previously, the bank had also aimed to limit CHF gains in order to preclude deflationary tendencies. However, February inflation registering the fastest pace since October 2008 at 2.2% creates a policy conundrum for the central bank. Consumer prices extending beyond the target threshold suggest the SNB should consider tightening. However, as around 1.0% of the gain was a result of energy prices, should we energy costs level off or ease over the next 12months, the need to tighten will quickly diminish. The market currently implies around 40bps of tightening by year-end, similar to that of the ECB. We expect a less aggressive rate profile from the ECB and that will also likely be reflected by the SNB.

SEK

Jeremy Stretch

SEK set for liftoff as Riksbank hike expectations rise

Q2 2022: 10.20 | Q3 2022: 10.00 (EURSEK)

The SEK has proven to be the weakest performing major versus both the USD and EUR in the first quarter. The fact that the currency is highly leveraged to eurozone economic activity and broad risk sentiment underlines why SEK fortunes have remained closely correlated with Ukrainian war dynamics.

Despite the high correlation with the eurozone, the broad domestic data outlook remains robust. Q4 quarterly GDP came in above 1%. Forward-looking PMI remains at elevated levels, as the 3m MAV of both manufacturing and services PMI continue to hold above 60.

Elevated levels of household lending, near 7% on an annual basis into early 2022, have been contingent on exaggerated levels of services sentiment. With annual consumption growth remaining well above 5% into the start of the year, the need to tighten monetary policy extends beyond mere inflation dynamics. But inflation signals clearly lean that way as well. CPIF materially beat expectations in February, as annual prices reached 4.5%, double the target and the highest since 1993. Central bank Governor Ingves has now conceded that rates are set to rise well before previous assumptions of 2024. Should CPI remain elevated and external risks moderate we would expect the market to increasingly price in a hawkish Riksbank bias, validating our positive SEK outlook. We anticipate EUR/SEK trading back towards 2021 lows into H2 2022.

Commodity FX
NOK

Jeremy Stretch

All signs point to NOK outperformance in H2

Q2 2022: 9.75 | Q3 2022: 9.65 (EURNOK)

Although the NOK does not suffer from the same high beta risk-orientated characteristics as the SEK, its pro-cyclical nature has moderated NOK performance over recent weeks. The aggressive uptick in Brent crude

should have further enhanced an already positive trade position and fiscal backdrop, but the retreat in the weekly correlation between Brent crude and EUR/NOK has proven to contain NOK gains.

Beyond oil price dynamics, we view the uptick in the forward-looking components of the February Norges bank regional agents survey as underpinning a continued tightening bias. The most recent output survey revealed that forward-looking business sentiment, six months ahead, rebounded strongly last month, likely helped by an easing in Covid restrictions. The uptick in price pressures risks eroding consumer purchasing power. Annual headline inflation looks set to come in at around 3.0%, as core price pressures are set to persist. That underlines the presumption of the central bank tightening by around 100-125bps in 2022.

A tight labour market points towards average earnings remaining elevated. Positive real earnings, in contrast to many other markets, risk a perpetuation of financial sector imbalances. While the central bank looks set to continue to tighten, we also expect additional macro-prudential measures to limit concerns over broadening household imbalances.

While NOK gains may have not proved commensurate with recent oil price impetus, the combination of rate support and underlying growth dynamics, supported by a positive fiscal backdrop, favours modest outperformance versus both the USD and EUR in H2.

AUD

Patrick Bennett

Further gains ahead

Q2 2022: 0.75 | Q3 2022: 0.77 (AUDUSD)

Our view on AUD in recent months has been consistent in recommending buying the currency into occasions of weakness. In February we wrote that “support for the AUD is a combination of solid and improving fundamentals, the evolving stance of the RBA (which has implications for portfolio demand), plus commodity demand and firm commodity prices. We have also seen the market positioned overly short of the currency. On valuation, we judge AUD to be undervalued vs long-term interest rate differentials and Australia’s terms-of-trade.”

Australia’s economic recovery is evidenced through a very strong labour market and a robust recovery in activity levels from the depths of virus driven lockdowns last year. Of particular note in the case of Australia is the relative lack of inflation pressure vis-à-vis its economic peers. That situation, and it is still evolving, prompts the RBA to say they can be patient before raising rates. The RBA being later to raise rates than other major central banks need not be a headwind to the currency. Instead, the resultant continued accommodative support for activity and assets can help, not hinder the currency performance. We expect the RBA to begin raising rates in 3Q.

Following the end to RBA QE earlier this year, and the more general move to higher yields globally, the yield on AU10s has risen, last around 2.71%, the differential AU-US10s has also widened from near 15bps in February to last near 38bps. Yields are the highest since June 2018, when the differential AU-US10s was -80bps, and AUD/USD was trading near 0.7100. The turn in the spread in favour of the AUD, and expected further moves in that direction, will bolster AUD/USD support.

NZD

Patrick Bennett

NZD: A quiet achiever

Q2 2022: 0.70 | Q3 2022: 0.71 (NZDUSD)

Most market attention in recent weeks has been directed either at the FOMC or unfolding events in Ukraine. During the same time, the RBNZ has hiked rates again, taking the cash rate to 1.00%, and the currency has been the second-best performing major currency ytd, having gained (an admittedly modest) 0.70% against the USD, shaded only by the 1.8% gains for the AUD.

RBNZ hawkishness that began in 2021 will continue this year. The earlier start than other major central banks might have been suggestive of being able to do more then and less later. Though as elsewhere, inflationary pressures, and in the particular case of New Zealand, labour and wage pressures remain. For the currency, the currently priced terminal rate referencing 5y5y swaps and relationship with the value of the currency, shows the NZD/USD as undervalued. The undervaluation is similar when considering the spread between 10year bond yields and NZD/USD.

As the market begins to refocus on New Zealand data and the likely path of RBNZ tightening - we expect the NZ policy rate to reach 2.00% in 1Q next year- we see support for NZD/USD building. A key risk to that result, is the possibility of greater hawkishness from the RBNZ than is priced, and as a result a greater headwind to domestic activity. That is already showing via a moderation in house prices.

ZAR

Jeremy Stretch

ZAR to weaken ahead on exits from domestic bonds

Q2 2022: 16.00 | Q3 2022: 15.80 (USDZAR)

The first quarter has seen the USD benefit from either a liquidity or growth/monetary tightening premium. As a consequence, all but a handful of EM currencies have depreciated versus the greenback. Unsurprisingly, the outperformers are those that have benefitted from improving terms of trade via substantive gains in commodity revenues. Although South Africa's two primary commodity exports, gold, and platinum, may have come off from nominal highs, prices are still 7-8% higher year to date. Rising commodity revenues are set to boost an already elevated current account surplus. While export revenues soar, the country is only a modest net oil importer. Moreover, as direct trade linkages with Russia are limited, this proves to underline why the currency has outperformed the bulk of its commodity peers.

While the country may only be a modest oil importer, the potential price pass-through into CPI risks a more aggressive reaction from the SARB. Median rate expectations now point towards official rates heading back towards 5.5% by the end of 2023. The combination of rising nominal rates and elevated commodity revenues have encouraged a rapid and aggressive accumulation of ZAR long positions. Investors have moved from neutral positioning into the start of the war in Ukraine, to longs not seen since July 2017. The rapid accumulation of ZAR positions has resulted in USD/ZAR trading below the 200Day MAV for the first time since early Q4 2021. However, external investors have recently been material net sellers of domestic bonds, pointing towards a potential correction of recent ZAR gains.

LATAM FX
MXN

Luis Hurtado

Limited room for hawkish surprises

Q2 2022: 22.0 | Q3 2022: 22.0 (USDMXN)

Following the rapid and large magnitude spikes during global risks episodes, USD/MXN has returned back to its pre-war in Ukraine levels at around 20.30. As we've mentioned in previous notes, carry is one of the biggest advantages for the MXN given the electoral risk embedded in the COP and the BRL, along with the new constitution process in Chile. Moreover, continuous upside surprises in inflation have pushed the market to price in over 200 bps in rate increases over the next eight meetings. Nevertheless, although we agree with the need to frontload the tightening cycle in Q1, we do not expect an acceleration of the cycle this year.

A look at the ex-ante real policy rate shows that only 80-160 bps in additional rate hikes (not counting the March decision) are needed to bring the real policy rate to the upper half of Banxico's neutral real policy range, suggesting limited room for a further increase in rates in the 1Y range. Hence, we find it difficult to believe that the 50 bps pace of rate increases will be maintained for a prolonged period, a view backstopped by the current division among the board members and the negative surprises in economic activity numbers. Therefore, despite the attractiveness of the MXN carry on less convoluted local politics, we maintain our upward USD/MXN bias towards the 20.90 mark from current levels.

BRL

Luis Hurtado

BCB tightening cycle decelerated, but hawkish tone remains

Q2 2022: 5.70 | Q3 2022: 6.00 (USDBRL)

In an unanimous decision, the Banco Central do Brasil increased the Selic rate by 100 bps to 11.75%. The March decision was not a surprise as the BCB clearly stated its intention to decelerate the pace of monetary tightening at the previous meeting. Nevertheless, the announcement had various hawkish hints.

First, the central bank highlighted the higher-than-expected inflation print in recent months, and the inflationary pressures arising from global uncertainties. Second, once again, the BCB reiterated its concerns regarding the fiscal outlook. Third, and most importantly, the BCB's revised inflation outlook showed a concerning trend for the rest of 2022 and, in our view, support an extension of the tightening cycle beyond May's rate announcement. Hence, although the BCB called for serenity when assessing the extension and duration of current shocks, we no longer expect the BCB to end the tightening cycle at 12.75%, and we have revised our Selic terminal rate forecast to 13.25% by the end of Q2 2022.

Following an impressive rally so far in 2022, USD/BRL has hovered around 5.10 before falling in mid-March. Although concerns regarding new fiscal measures are likely to keep pressure on the BRL into Q2, we expect the BCB's hawkish tone to provide space for a USD/BRL tactical move to 4.98. At which point, we suggest

entering into long USD/BRL plays back to the 5.30 mark with a 4.90 stop loss.

CLP

Luis Hurtado

BCCh Dials up its hawkish tone

Q2 2022: 780 | Q3 2022: 800 (USDCLP)

Despite our initial slight upward revision in the terminal rate forecast to 7.25% following the January rate announcement, the most recent inflation prints, in tandem with the decidedly hawkish meeting minutes and recent comments from the BCCh governor, have prompted us to revise our terminal rate forecast significantly higher to 8.75% for Q2. Moreover, we expect the BCCh to revise its quarterly forward guidance significantly higher, as suggested in the rate announcement. Note that the BCCh's current monetary policy range path places the ceiling of the range at an average of 5.50% in Q1, 6.50% in Q2, and peaking at around 6.75% in Q3.

A look at USD/CLP shows that dissipating political issues and persistently high copper prices have supported the CLP since the start of the year. However, given the market's focus on the Fed's tightening cycle, geopolitical news, and the risks related to the new constitution process in H1 2022, we do not see much room for USD/CLP to maintain a sustained downward trend below 790 (778-780 is the next level to watch).

COP

Luis Hurtado

Exercise caution with COP

Q2 2022: 4100 | Q3 2022: 4000 (USDCOP)

Gustavo Petro was chosen as the presidential candidate for the Pacto Historico coalition (left), with over 4mn votes. Moreover, while a majority wasn't achieved, preliminary results show that Pacto Historico obtained the most seats in the Senate, and the second highest number in the Chamber of Deputies. These results confirmed our expectations of a much larger representation of the left in both, and give Gustavo Petro a good start ahead of the first-round election in May. Although some headlines have suggested that Gustavo Petro not achieving a majority in congress as the main reason behind the COP rally in mid-March, risks regarding a possible alliance with the liberal party and other smaller leftist parties remain in place and should not be thought of as low probability outcome.

Moreover, despite the significant rally in oil prices over the last month, it is important to note that Colombia faces significant structural challenges. First, its current account deficit reached 5.7% of GDP in 2021, the highest deficit seen since 2015. Of course, the increase in oil prices over the last few weeks is likely to contain a further deterioration this year. However, Colombia's oil production has been declining, while current politics suggest significant risks for new exploration and, consequently, lower investment in the sector.

Second, domestic demand resilience has put significant pressure on the commercial balance. This situation poses a significant issue for the central bank as, despite the depreciation of the COP, the current account deficit has shown little sign of improvement beyond the initial demand contraction following the onset of COVID-19. Hence, as inflation surprised to the upside in February, we now expect Banrep to increase the overnight rate by 125 bps (100bps previously) in March, and by another 125 bps in May (100bps previously). That being said, expectations for a further acceleration in the tightening cycle should be kept in check by the government's announcement that it will reduce some tariffs, and by the recent appreciation of the COP, limiting further downside in USD/COP from current levels. Hence, despite the initial positive reaction for the COP, we maintain our upward USD/COP bias towards the 4000 mark.

Asia FX
CNY

Patrick Bennett

CNH: Economic stability and support

Q2 2022: 6.25 | Q3 2022: 6.20 (USDCNY)

The overarching message from the recently concluded NPC was of a focus on economic stability. A GDP target for this year has been set at "around 5.5%", a number that is broadly in line with expectations. The target compares favourably to the 8.1% growth achieved in 2021, but less so to the 4% running rate seen in 4Q. In order to achieve the target, Chinese authorities are widely expected to extend current stimulus settings. We anticipate another 50bps RRR cut and 10bps reduction in policy and prime rates in 2Q.

On fiscal policy, the NPC announced a deficit target of 2.8% of GDP this year vs 3.2% in 2021. While at face value that is less expansionary, the actual deficit in 2021 did not reach target. The carry-over funding from 2021, plus adding in issuance of local government bonds, takes the expected actual broad fiscal deficit to 7-8%.

For monetary easing and targeted stimulus to be successful in supporting growth this year, a reduction in headwinds from China's zero-COIVD approach,

maintenance of moderate external demand, and absence of excessive inflationary pressure, will all be required.

For financial markets, the stability of the yuan over recent months has been notable. Despite the ebb and flow of global risk appetite, the Chinese currency has tracked an overall steady appreciation path, and we expect that to continue. As was the case last year, we anticipate monetary authorities will be comfortable to allow the stronger currency to dampen the inflationary impact of higher commodity imports. In doing so, that can aid in support of domestic consumption, rather than promote a weaker currency in order to bolster exports.

Alongside allowing the currency to dampen imported inflationary pressure, another cornerstone of stability and overall appreciation of the yuan has been foreign portfolio inflow to China. The latest data showing divestment of holdings during February are a cautionary flag. The selling of bonds in February was the first monthly outflow since March of last year, while we have to go back to February 2019 for another negative month. Some speculation is that the selling may have been sourced from Russia, though without a breakdown of the transactions, that cannot yet be validated. Given the timing of previous outflow, we also consider that repatriation ahead of the end of financial year in Japan may be a contributing factor.

A narrowing of the interest rate differential between China and other majors may also be a straightforward explanation to some divestment. Though we note that while the Chinese yield advantage has been narrowing for some time, it has recently stabilised. We have previously raised the narrowing as reason to be cautious of extrapolating downside in USD/CNH. We will continue to track these flows and differentials. But at this point, we are comfortable to maintain our view of further downside in USD/CNH in coming months.

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