

# CIBC FICC Strategy and Economics

## FX MONTHLY

February 2024

## Positive Tension

### Key points

- Moderation in USD upside reflects changes in Fed thinking as progress on inflation is made and as real policy rates reach their tightest levels in over 16 years.
- We still don't agree with how markets are pricing the BoC and a re-pricing in CAD OIS is consistent with a final leg of CAD weakness in the coming quarter.
- While the ECB isn't 'date dependent', we still won't have a clear picture of wages until the spring. That points to a corrective move in EUR OIS which should keep the common currency supported on the crosses.
- We expect the BoJ to exit negative rates in April, while additional tweaks to YCC should support the JPY into H2.
- For the MXN, slowdowns in remittances and vehicle exports portend to downside in the coming quarters.
- In China, the RRR cut won't offset investor pessimism regarding the domestic economy.

### FX Forecasts

| End of period: | Jan 30, 2024 | Q1 '24 | Q2 '24 | Q3 '24 | Q4 '24 | Q2 '25 | Q4 '25 |
|----------------|--------------|--------|--------|--------|--------|--------|--------|
| USD / CAD      | 1.34         | 1.38   | 1.37   | 1.35   | 1.35   | 1.30   | 1.29   |
| EUR / USD      | 1.08         | 1.07   | 1.10   | 1.11   | 1.12   | 1.14   | 1.16   |
| USD / JPY      | 148          | 147    | 144    | 140    | 135    | 130    | 130    |
| GBP / USD      | 1.27         | 1.25   | 1.27   | 1.28   | 1.29   | 1.31   | 1.35   |
| USD / CHF      | 0.86         | 0.89   | 0.88   | 0.88   | 0.88   | 0.89   | 0.88   |
| USD / SEK      | 10.43        | 10.61  | 10.14  | 9.86   | 9.69   | 9.34   | 8.97   |
| AUD / USD      | 0.66         | 0.66   | 0.67   | 0.67   | 0.68   | 0.69   | 0.70   |
| NZD / USD      | 0.61         | 0.62   | 0.63   | 0.63   | 0.65   | 0.66   | 0.67   |
| USD / NOK      | 10.46        | 10.51  | 10.18  | 10.00  | 9.78   | 9.47   | 9.22   |
| USD / ZAR      | 18.90        | 18.85  | 18.35  | 17.75  | 17.35  | 17.00  | 16.75  |
| USD / BRL      | 4.95         | 5.00   | 5.20   | 5.20   | 5.00   | 5.20   | 5.20   |
| USD / MXN      | 17.22        | 18.00  | 18.20  | 18.50  | 18.00  | 18.00  | 17.50  |
| USD / COP      | 3932         | 4100   | 4300   | 4300   | 4100   | 4100   | 4000   |
| USD / CLP      | 933          | 900    | 880    | 850    | 830    | 820    | 840    |
| USD / CNH      | 7.19         | 7.20   | 7.25   | 7.20   | 7.15   | 7.10   | 7.10   |

### CAD Crosses

| End of period: | Jan 30, 2024 | Q1 '24 | Q2 '24 | Q3 '24 | Q4 '24 | Q2 '25 | Q4 '25 |
|----------------|--------------|--------|--------|--------|--------|--------|--------|
| CAD / JPY      | 110          | 107    | 105    | 104    | 100    | 100    | 101    |
| CAD / CHF      | 0.64         | 0.64   | 0.64   | 0.65   | 0.65   | 0.68   | 0.68   |
| AUD / CAD      | 0.88         | 0.91   | 0.92   | 0.90   | 0.92   | 0.90   | 0.90   |
| GBP / CAD      | 1.7          | 1.73   | 1.75   | 1.73   | 1.74   | 1.70   | 1.74   |
| EUR / CAD      | 1.46         | 1.48   | 1.50   | 1.50   | 1.51   | 1.48   | 1.50   |

## EUR Crosses

| End of period: | Jan 29, 2024 | Q1 '24 | Q2 '24 | Q3 '24 | Q4 '24 | Q2 '25 | Q4 '25 |
|----------------|--------------|--------|--------|--------|--------|--------|--------|
| EUR / JPY      | 160          | 157    | 158    | 155    | 151    | 148    | 151    |
| EUR / GBP      | 0.86         | 0.86   | 0.86   | 0.87   | 0.87   | 0.87   | 0.86   |
| EUR / CHF      | 0.94         | 0.95   | 0.96   | 0.98   | 0.99   | 1.01   | 1.02   |
| EUR / SEK      | 11.3         | 11.35  | 11.10  | 10.95  | 10.85  | 10.65  | 10.41  |
| EUR / NOK      | 11.34        | 11.25  | 11.15  | 11.10  | 10.95  | 10.80  | 10.70  |

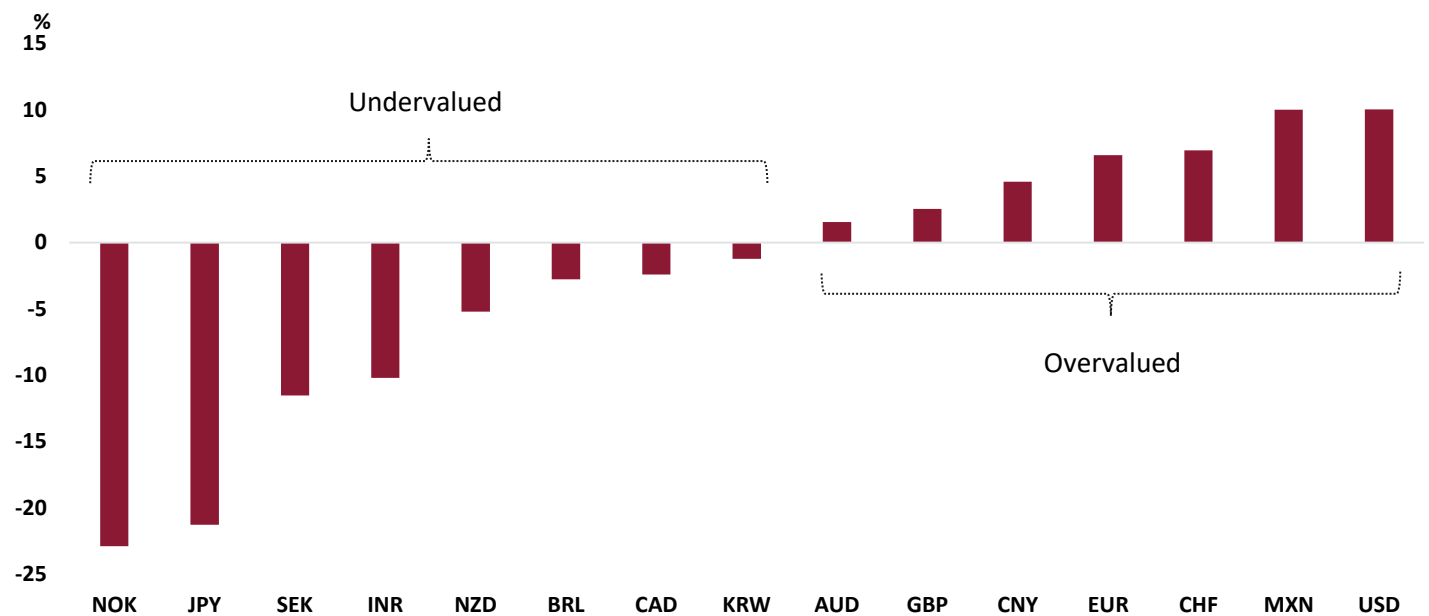
## Central Bank Forecasts

|         | Current | Q1 '24 | Q2 '24 | Q3 '24 | Q4 '24 |
|---------|---------|--------|--------|--------|--------|
| Fed     | 5.38    | 5.38   | 5.38   | 4.88   | 4.38   |
| BoC     | 5.00    | 5.00   | 4.75   | 4.00   | 3.50   |
| ECB     | 4.00    | 4.00   | 3.75   | 3.50   | 3.25   |
| BoE     | 5.25    | 5.25   | 5.25   | 5.00   | 4.75   |
| SNB     | 1.75    | 1.75   | 1.50   | 1.25   | 1.25   |
| BoJ     | -0.10   | -0.10  | 0.00   | 0.10   | 0.25   |
| RBA     | 4.35    | 4.35   | 4.35   | 4.10   | 3.85   |
| RBNZ    | 5.50    | 5.50   | 5.50   | 5.25   | 5.00   |
| Banxico | 11.25   | 11.00  | 10.50  | 10.00  | 9.25   |
| BCB     | 11.75   | 10.75  | 9.50   | 9.00   | 8.75   |
| BCCh    | 8.25    | 7.50   | 6.00   | 5.00   | 4.50   |
| Banrep  | 13.00   | 12.00  | 10.75  | 9.25   | 8.25   |

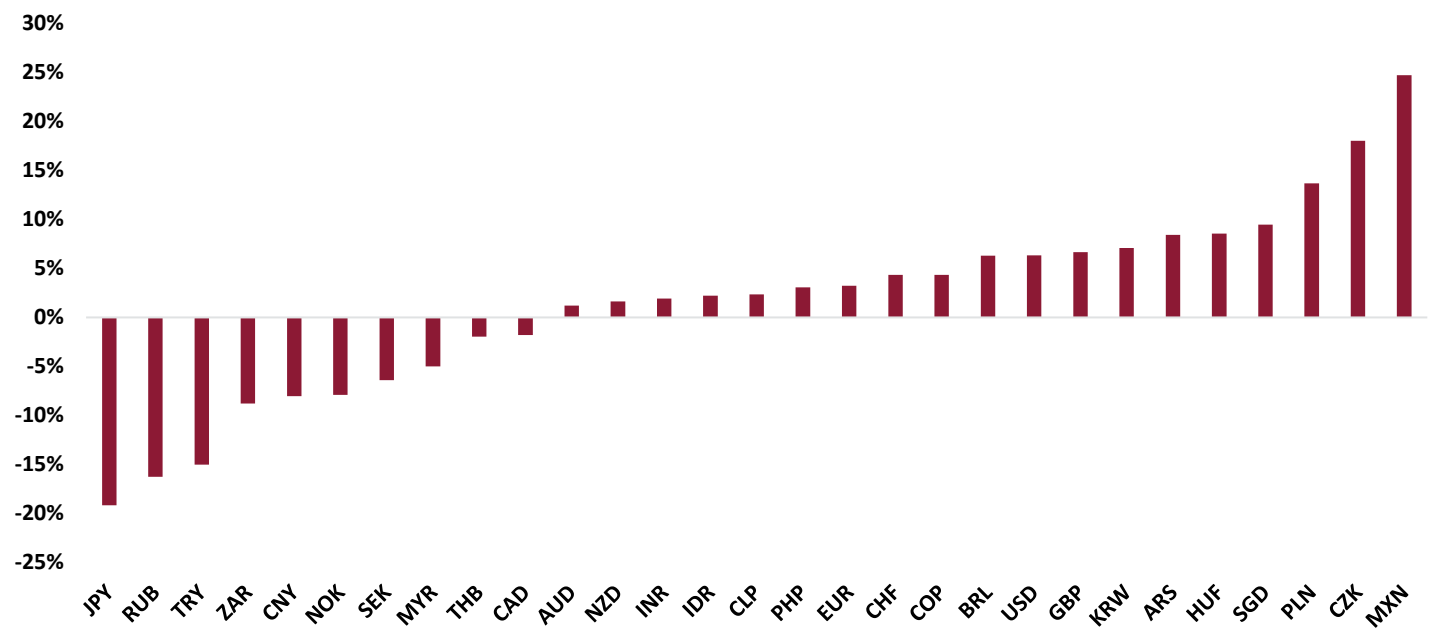
## Market Pricing

|      | Next Meeting | What's Priced | Q1 '24  | Q2 '24  | Q3 '24   | Q4 '25   |
|------|--------------|---------------|---------|---------|----------|----------|
| Fed  | Mar 6        | -2 bps        | -2 bps  | -54 bps | -59 bps  | -102 bps |
| BoC  | Jan 31       | -1 bps        | -12 bps | -57 bps | -102 bps | -136 bps |
| ECB  | Mar 7        | -6 bps        | -6 bps  | -53 bps | -105 bps | -143 bps |
| BoE  | Feb 1        | -1 bps        | -4 bps  | -32 bps | -73 bps  | -110 bps |
| RBA  | Feb 5        | 1 bps         | -1 bps  | -12 bps | -27 bps  | -42 bps  |
| RBNZ | Feb 27       | 1 bps         | 1 bps   | -14 bps | -66 bps  | -89 bps  |

## Long-Term Fair Value Model - BEER



## Long-Term Fair Value Model – REER Reversion



\*CIBC's BEER model gauges theoretical fair value for trade-weighted FX indices. This is done through a single panel regression over a long time horizon based on fundamental factors (including current account, terms of trade and labour productivity).

\*\*CIBC's REER reversion model looks at the deviation of a real effective exchange rate index from its long-term average.

## USD – Near-Term Strength to Provide Opportunities for Hedging

**DX** – Q1 2024: 104.83 | Q2 2024: 102.39

It's been a strong start to the year for the USD. Our preferred trade-weighted gauge is up 1.5% since the calendar rolled to 2024, as investors recalibrate views on the US economy and the path forward for the Fed over the next 12 months. Also, cursory glances at the futures market flag that non-commercial investors (notably asset managers) have been paring USD shorts over the past few weeks. Naturally, it's not a stretch to imagine that this paring is reflective of the same themes that have been playing out in SOFR futures – which have shifted to imply less easing from the Fed relative to late December.

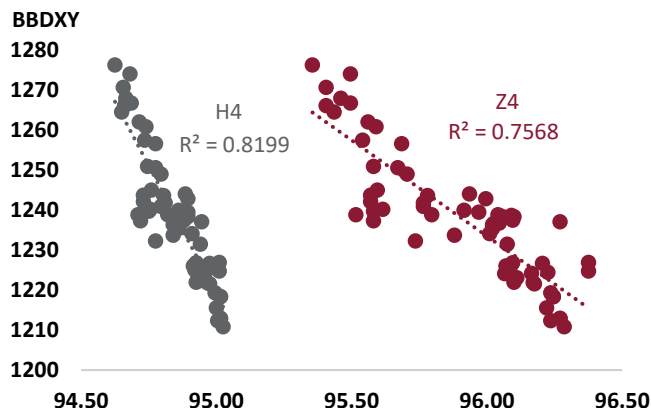
In our minds, the catalyst for this reassessment has been the resiliency of the US economy. That's been reflected in recent of data – most notably the impressive 3.3% annualized clip for growth in the last quarter in 2023. On a deeper level, we feel that the data is reacting to two important (and underappreciated) themes. The first is the degree by which real wages remain elevated, while the second is expansionary fiscal policy. Both are working to maintain a firm profile for domestic demand, even as nominal rates are at 'restrictive' levels. Indeed, we expect that both of these drivers will continue to make their presence felt in data for the coming months.

Nevertheless, the Fed is getting closer to a rate cut, and we still expect upcoming communication to be in sympathy with that view. While real activity has been impressive, the ongoing decline in year-over-year gauges for prices imply that the supply side is making progress in lock-step. That lends credibility to the message that Powell has been pushing for months now - that progress on price pressures can be made even with strong activity (akin to a 'soft landing'). With the real Fed funds rate now close to 280bps, the next step should be a cut as a 'hat tip' to the progress made on inflation thus far.

The call here is for the Fed to start easing rates in July. As the market re-prices to that timing, the USD should still gain a bit more in the near-term. But into H2, we expect the theme of USD weakness to pick up steam as the Fed looks to slow its own version of quantitative tightening (QT) which would put it at odds with how other central banks are proceeding with their own programs. Additional drags should come from relatively hawkish policy outside of the US (Japan and the UK), continued deficit spending in the US, and the general sense of overvaluation for the greenback on a longer-term basis.

Canadian-based exporters and asset managers should look to take advantage of near-term USD strength to lock-in hedges at more attractive levels.

**Chart: A repricing of SOFR futures is consistent with a stronger USD**



Note: 3m observation window

Source: CIBC Capital Markets

## CAD – Final Leg Weaker Before an Appreciation

**USD/CAD** – Q1 2024: 1.38 | Q2 2024: 1.37

The loonie has been retracing gains made late last year, and will likely continue to depreciate over the first quarter as markets recalibrate central bank rate expectations. The Bank of Canada took the first step towards pivoting to rate cuts in its January announcement, revealing that the discussion is now about how long they need to keep rates at this level, and ascribing a forecast for better second half growth to easing financial conditions. While the Bank sees inflation as sticky, it's paving the way to cut rates once much of the excess above its 2% target is concentrated in shelter, where slower population growth ahead will be key to containing rents, and rate cuts will help with mortgage interest costs. We see that as coming to fruition by Q2, paving the way for a first cut no later than June, with 150 bps in total reductions this year

being necessary to generate the sort of economic upturn the Bank is counting on.

Canada's economic doldrums since Q1 of 2023 contrasted sharply with an acceleration south of the border. So although the US has made solid progress on core PCE inflation, the Fed isn't looking at an economy in dire need of early or aggressive interest rate relief. Until more of a slowdown has taken hold, there are risks that too much stimulus could see inflation reaccelerate, with much of the deflationary benefits from supply chain improvements now behind us. In contrast to market expectations, we see the Fed delivering only 100 bps of cuts this year, and waiting until Q3 when more slack will have emerged to get the ball rolling. As markets reprice Fed and BoC expectations in opposite directions, we see USD/CAD drifting up to 1.38 in early spring. Thereafter, broad USD weakness as the Fed prepares to start cutting rates should give the C\$ a lift, and the loonie will be boosted further in 2025 by a global pickup in demand and higher commodity prices. We look for USD/CAD to reach 1.29 by the end of 2025.

## EUR – Testing ECB Patience

**EUR/USD** – Q1 2024: 1.07 | Q2 2024: 1.10

The Q4 ECB Bank lending survey detailed that Eurozone financial institutions continue to impose tighter lending standards. However, there are signs of a moderation in the credit demand downtrend. While there may be signs of a bottoming out in activity, as policy tightening has reached its conclusion (after ten adjustments), we expect immediate monetary policy inertia. In terms of macro dynamics, we would underline weakening real economy data, including weak German factory orders, reflecting Chinese demand dynamics and ongoing Red Sea supply pressures. Although German manufacturing PMI may have rebounded from July 2023 extremes (38.8), the protracted sectoral correction, underlines Eurozone macro malaise.

In terms of the ECB reaction function, we are still of the opinion that a data-dependent central bank will remain cautious. Although core prices continue to correct, policymakers faced an uptick in flash headline HICP into year-end, as end-2022 energy support measures rolled off. However, as Eurozone flash HICP ended the year below 3%, we still expect core and headline inflation to potentially undershoot recent ECB staff forecasts. This supports the notion that the next move is lower.

In terms of policy timing, we expect the ECB to remain mindful of persistent second-round price effects, namely wages. ECB Chief Economist Philip Lane has detailed that the bank will not have full Eurostat wages data until after the April policy meeting. Therefore while some ECB members may be keen for a spring policy adjustment, we would expect the bank to be reticent to act before June. Although markets fixate on the timing and extent of ECB policy adjustment immediate EUR/USD performance remains largely a function of the Fed, rather than the ECB.

## JPY – BoJ Still Waiting for Wage Growth

**USD/JPY** – Q1 2024: 147 | Q2 2024: 144

The tragic Noto Peninsula earthquake which took place on New Year's day has pared the market's previous hawkish assumptions about a Q1 rate hike. Wages are making progress, but the uncertain economic impact from the earthquake argues for more patience/caution. Even before the earthquake, our base case was that the BoJ would wait until the April 26th meeting to adjust policy rates higher.

During the January 23rd BoJ press conference, Governor Ueda noted that the MPC "will examine incoming data at every meeting" and that "certain amount of information will be available before the March meeting." We think Ueda was merely stating facts, not hinting at a March move. As such, we think it would be premature for the BoJ to hike before the *shunto* wage negotiations are finished. Although current and former officials have noted there are positive signs of increases in the ongoing wage talks, it still makes sense for the BoJ to wait until the *shunto* talks are over and wage gains are "locked-in."

That would give the "virtuous cycle" of wage-price gains (which the BoJ has been seeking for years) a chance at sustainability. We expect USD/JPY has already peaked and should trade back to 147 in Q1 before declining towards 144 in Q2 (after a "dovish" BoJ rate hike in April – rates will likely be increased but BoJ guidance will still be dovish). Thereafter we expect Fed cuts and the outlook for gradual BoJ YCC adjustments to push USD/JPY to 140 in Q3 and 135 in Q4 2024.

## GBP – BoE to Remain Restrictive

**GBP/USD** – Q1 2024: 1.25 | Q2 2024: 1.27

We expect the UK economy will skirt an outright 2024 contraction. That being said, the risk of the economy having ended 2023 in a technical recession remains real. The aggressive 3.2% decline in December retail sales (we have not seen a steeper correction since lockdown in January 2021), increases the risks of Q4 GDP matching Q3 (-0.1%). Final Q3 GDP

was negatively impacted by the weakest household consumption outturn since Q3 2022, with a reading of -0.5%. We anticipate consumer headwinds to be reflected in provisional Q4 GDP due on 15 February.

Technical recession risks remain a function of elevated precautionary saving or reduced discretionary spending. The latter comes despite five straight gains in real earnings. The uptick comes as mortgage rates have corrected from recent extremes. Nevertheless, mortgage holders remain mindful of the impact of refinancing dynamics. Moreover, we would note signs of a loosening labour market, job vacancies have fallen by more than a quarter in the last 18 months.

In terms of BoE policy dynamics, we would note that the inflation downtrend unexpectedly stalled into the end of 2023. However, one-off factors such as rising airfares and increases in administered alcohol and tobacco prices are unlikely to be repeated. Indeed substantive CPI base effects suggest headline inflation could test 3% into Q2. Yet despite the CPI downtrend, we expect relative BoE policy inertia. We anticipate the BoE is likely to continue to preach policy patience as wage growth remains inconsistent with the CPI target while the prospect of a politically inspired fiscal easing in the 6 March budget amplifies policy complications. We anticipate that the BoE will not ease until August. Although higher rates should prove GBP supportive, we remain mindful of sentiment proving compromised by a combination of rising electoral risk and macro stagnation.

## CHF – SNB No Longer Sanctioning CHF Strength

**EUR/CHF – Q1 2024: 0.95 | Q2 2024: 0.96**

After proving the major 2023 G10 outperformer, it appears increasingly evident that the monetary authorities have turned away from sanctioning ongoing CHF strength. In this context we would note that the SNB adjusted its currency language at its December quarterly policy meeting, removing its previous bias regarding ongoing sales of foreign currency. The omission of FX references underlines that the central bank has become increasingly concerned over the impact of the CHF on both macro performance and perhaps more importantly the inflation profile.

SNB Chief Jordan may believe that the battle against inflation is “not completely won”. Yet despite such presumptions, the SNB revised down its CPI profile, by around 0.2% percentage points across the forecast profile in its December quarterly bulletin. The bank now anticipates that prices will be below the target threshold in 2026, 1.9% vs 2.1% previously. The bank currently assumes that monetary policy conditions are appropriate. However, CPI is set to remain below target, while weak demand dynamics predominate. The combination of disinflationary dynamics and an SNB who is increasingly mindful of a strong currency points towards a graduated weakening in the CHF.

Currently, the market anticipates more ECB activism into mid-year (-53bps) than for the SNB (-42bps). We would view both as likely to consider a more modest degree of policy easing. Given the prospect of a more aggressive paring in ECB rate cut assumptions this points towards EUR/CHF heading towards the 200Day moving average, modestly above 0.96 into mid-2024.

## SEK – FX Hedging Impacts

**EUR/SEK – Q1 2024: 11.35 | Q2 2024: 11.10**

The late Q4 global equity rally, predicated upon aggressive global rate cut presumptions, resulted in the SEK proving to be the top performer against both the EUR, (up 4.2%) and the USD (9.8%) over the last two months of 2023. While the SEK's high beta status was a factor, we would also note the impact of ongoing central bank currency hedging. In this context, we would reiterate the impact of the Riksbank's 25 September announcement of plans to sell both USD and EUR.

At its inception, the Riksbank anticipated that the process to sell some US\$8bln and €2bln would take around 4-6 months. However, into the week ending 12 January, central bank selling has resulted in the Riksbank reaching 89% of its USD target and 78% for the EUR. The late 2023 SEK gains encouraged several central bank members to underline that additional policy tightening would be unnecessary. We would view the accelerated pace of FX hedging as suggestive of the fact that the central bank remains mindful of the impact of imported price pressures.

Beyond risk and FX hedging dynamics, we would note that domestic macro data has witnessed a modicum improvement. For example, composite PMI has witnessed three straight gains for the first time since H1 2021. The perpetuation of PMI gains, allied to Riksbank policy inertia, suggests that even as central bank FX hedging moderates, we remain biased towards medium-run SEK impetus.

## NOK - Norges Bank to Remain a Policy Outlier

**EUR/NOK – Q1 2024: 11.25 | Q2 2024: 11.15**

Recent macro data, whether it be November mainland GDP, industrial output, or December PMIs have underlined relative

macro resilience. In terms of the latter, we would note a second straight month of substantive activity gains has resulted in the series advancing well beyond the 6m MAV. Although we may have witnessed Q4 industrial confidence retreat towards early 2023 lows at -4.9, we would note that the economic surprise index advanced to levels not witnessed since August into early 2024.

Consumer price pressures moderated at a slightly faster pace than expected in December. However, core prices remained at 5.5%, just 1.50% below the June peak, which underlines that we would expect the Norges Bank to remain something of a policy outlier. After being an early adopter of policy tightening in September 2021 we would expect the bank to be far less aggressive on the way down. The combination of still-tight labour markets and elevated wage levels underlines that the central bank is likely to be cautious in terms of policy reversal. The market is currently pricing in 19bps of easing by the June central bank decision, with a further near 70bps discounted through H2. We would expect the bank to be rather more cautious. We expect policy reticence to encourage a stronger NOK bias, moderating imported inflationary dynamics in the process.

## AUD – Slowing Job Growth Won't Cause the RBA to Panic

**AUD/USD – Q1 2024: 0.66 | Q2 2024: 0.67**

The December jobs report confirmed that labor market demand is slowing, we think it is too soon for the RBA to declare victory and start thinking about the easing cycle so soon after the November hike. We suspect seasonal adjustment factors may have played into the December jobs decline (and the overly strong job gains in October and November). When looking at job growth on a quarterly basis, Q4 jobs still grew by +52k. That is positive, but is indeed a slowdown from pace of +72k in Q3 and +108k in Q2.

The slowdown in quarterly job growth argues for an extended RBA pause. Our simple model of Australian Phillips curve confirms that labor conditions are still too tight for CPI to return to the RBA's target range of 2-3%, and the RBA will wait for demand to weaken further before cutting. The latest IMF Article IV Consultation on Australia (published on January 20th) confirms this mildly hawkish view – the IMF even argues that further rate hikes are needed (contrary to market expectations for cuts).

We do not expect RBA cuts until Q3 or later (after the Fed). Stable RBA policy amid Fed cuts, and strength in the Australian services sector means that AUD should be relatively stable, despite ongoing China weakness. We think AUD/USD will continue to react to Fed expectations – with March FOMC pricing now at 50% chance for a cut, we think further AUD downside is limited, and maintain our AUD/USD forecast of 0.66 in Q1.

## NZD – Immigration, inflation and imports

**NZD/USD – Q1 2024: 0.62 | Q2 2024: 0.63**

The RBNZ's "hawkish hold" in November, whereby the central bank's own forecasts for the OCR were increased to reflect greater chance of hikes, came as a surprise to both us and markets. The RBNZ policy statement also added a new sentence on the possibility of additional hikes. The more hawkish overall message runs at odds with New Zealand's Q3 data. Counter-intuitively, the latest inflation forecast in the November MPS was actually lower for 2024 relative to the August MPS forecast.

The RBNZ has a focus on the inflationary impacts of immigration. The statement emphasized that services inflation is higher in economies experiencing high net immigration. During the November press conference, Governor Orr repeatedly mentioned the housing component of services inflation, and highlighted that although per capita consumption was steady, the net immigration increase was leading to aggregate demand issues in New Zealand.

Demand looks high relative to New Zealand's production capacity – high imports have pushed the current account balance into deep negative territory of -7.6% of GDP (vs a surplus in Australia). As such, we think the RBNZ is correct in its efforts to curb demand. That means the RBNZ will be later in cutting rates (after the RBA and well after the Fed), likely keeping the OCR elevated as the Fed cuts in Q3. Falling US yields amid the Q3-Q4 Fed easing cycle should help see carry inflows into New Zealand, which will help offset current account outflows and keep NZD elevated. We expect slight NZD/USD strength (to 0.63) by Q2.

## ZAR – International Investor Appetite Key

**USD/ZAR – Q1 2024: 18.85 | Q2 2024: 18.35**

Widening real yields, as underlying inflationary pressures continue to moderate, point towards ongoing international investor interest in South African assets, risk dynamics and domestic political considerations notwithstanding. Although inflationary pressures look set to continue to moderate, inflation expectations remain elevated. In this context, we can expect the central bank (SARB) to remain mindful of secondary wage pressures. Despite the presumption of a graduated

reduction in price pressures, we would expect the central bank to be cautious in terms of policy easing. Our view rests on supply side frictions, such as rail network and port-related restrictions, keeping the central bank from easing policy, from the current 8.25%, until at least 18 July central bank meeting.

Speculative ZAR longs have continued to advance into early 2024. Holdings have pushed beyond recent (October) cyclical peaks, to levels not witnessed since Q3 2022. The improved appetite for South African assets comes as real economy data underlines a slightly more constructive macro backdrop. The broad correlation between manufacturing sentiment and ZAR valuations suggests that should supply-side restraints, such as long-term load shedding (power cuts) continue to diminish, external interest in domestic South African assets should support medium-run ZAR gains. However, we remain mindful of ongoing political uncertainties as upcoming elections risk latent ANC hegemony being increasingly challenged.

## LATAM FX

### MXN – Changing Tides

**USD/MXN – Q1 2024: 18.00 | Q2 2024: 18.20**

We expect a few of the factors benefiting the MXN (i.e. carry, remittances growth, and manufacturing exports) in 2023 to offer a headwind for the MXN going forward, in line with our Q1 USD/MXN forecast of 18.00. For instance, remittances into Mexico grew at a mere 1.9% y/y in November, posting its lowest increase since April 2020. Furthermore, December's vehicle production dropped 9.9% y/y, its first year-over-decline since April 2022, and the largest drop since December 2021. Although one month does not make a trend, these indicators are noteworthy. The former has had a significant influence on the large amount of USD flows into the country over the last 3 years (USD165 bln), while the latter has been the only sector behind the increase in manufacturing exports during the second half of 2023.

Looking at prices, bi-weekly headline inflation came in at 4.90 y/y (0.49% m/m), higher than the 4.78% y/y (0.38% m/m) expected by consensus and the 4.86% y/y (0.48% m/m) posted at the end of December. Nevertheless, core prices maintained its downward trend landing at 4.78% y/y, down from 4.98% y/y, and matching consensus expectations. Although the headline surprise should provide some relief to the recent USD/MXN rally, the downward trend in core prices will likely provide some room for Banxico to explicitly state that they will start the easing cycle in March. Moreover, we do not rule out a dissident vote (a member in favour of a 25bps rate cut) in February should inflation expectations maintain its steady downward trend ahead of the meeting. We maintain our call for consecutive 25bps rate cuts starting in March. Also, we anticipate an increase in the magnitude of Banxico's rate cuts in late 2024, bringing the overnight rate to 9.25% (or 200bps worth of cuts) by year end. This compares to our revised forecast of four 25bps rate cuts by the Fed.

### BRL – Perpetual Fiscal Risks

**USD/BRL – Q1 2024: 5.00 | Q2 2024: 5.20**

USD/BRL retested the 5.00 level during the second half of January as the government announced a plan to spend BRL 300bln in industrial incentives. The plan increased investors' concerns with regards to the viability of the current administration's fiscal goals. As we have mentioned over the last few months, despite signs of progress with respect to revenue measures being approved, achieving the 2024 fiscal target remains a difficult task. The difficulty emanates from the deceleration in GDP growth and the government facing a stronger opposition in congress (i.e. larger odds of populist measures). A USD/BRL break above 5.00 would suggest a retest of the 5.05-5.10 range last seen in October/early November.

On the monetary policy front, we don't anticipate any changes to the cautious BCB rhetoric or the steady pace (50bps) of rate cuts in Q1, keeping upward pressures on USD/BRL contained at its October highs. Nevertheless, we point out that as GDP growth decelerates, and with two new government appointments at the central bank's board, we are likely to see increasing government pressure to at least maintain the same pace of rate cuts into Q2. This will likely reduce the attractiveness of the BRL's carry at a faster rate than currently expected by the market by the end of H1 2024. That said, we point out that barring a new external shock, the benevolent trend of the country's trade balance is likely to prevent an upward move beyond 5.20 in the coming months.

### CLP – Awaiting a Credible Central Bank Forward Guidance

**USD/CLP – Q1 2024: 900 | Q2 2024: 880**

Following the impressive CLP rally in November and part of December 2023, USD/CLP retested the 930 mark in January. The latest leg upward appears to reflect the better than expected CPI print in December and expectations that the CB may return to 100bps rate cuts. We highlight that the market is already pricing in a return to neutral by 2025 in line with

the latest CB estimates (the only country in the region already there), suggesting limited room for further dovish surprises from the monetary policy front. Moreover, remember that at the end of October the BCCh expressed concerns with the rapid depreciation of the CLP in Q3 2023, as it approached 950 and it reduced the pace of rate cuts on the back of this trend. This level should continue to act as a line in the sand for the CB. Thus, we expect the BCCh to err on the side of caution and only cut the overnight rate by 75bps on January 31st. An increase in the magnitude of rate cuts risks upward pressures on USD/CLP above 930, mimicking the market response following the lack of a credible forward guidance by the BCCh as seen in early H2 2023, and in mid-2022.

On the political front, the rejection of the new constitution process has unlocked the discussion of pending reforms in congress. The Lower House backed a base text of Boric's pension reform but unpopular articles, such as the destination of the new funds (6% of employee's salary – divided in individual savings and a solidarity fund) to be raised from employers, were rejected. Overall, we anticipate any reforms and/or radical ideas proposed by the government to be diluted in congress, preventing negative surprises to the CLP from the political front. Hence, provided a cautious message by the BCCh at the end of January, we see room for a USD/CLP correction lower towards 900 in line with our Q1 forecast.

## COP – Gearing Towards an Acceleration of the Easing Cycle

**USD/COP** – Q1 2024: 4100 | Q2 2024: 4300

The recent downside surprise in headline inflation has increased the odds of an acceleration of the easing cycle by Banrep in Q1. Recall that the ex-ante real rate in Colombia is 587bps above the Banrep's estimated neutral real rate, the most restrictive in the region. Hence, we expect Banrep to cut the overnight rate by 50bps in both its January 31st and March meetings, bringing the overnight rate to 12% by the end of Q1. Furthermore, we expect Banrep to accelerate the pace of rate cuts beyond March with the overnight rate ending the year at 8.25%. However, we highlight that the 12% increase in the minimum wage, and some risks with regards to the influence of El Niño on food prices will likely prevent the central bank from sounding too dovish in its January 31st meeting. This should contain upward pressures on USD/COP to its November's highs in the 4100-4150 range in line with our Q1 forecast.

On the fiscal front, despite compliance with the 2023 targets, the 2024 picture looks challenging. Here, we point out the government is expecting approximately 1.2% of GDP in extra revenues as a result of a positive outcome of arbitrations with tax payers. Moreover, although difficult to approve on their current state, upside risks to government spending and further political turmoil remain in place with the health, pension, and labour reforms still being discussed in congress.

## Asia FX

### CNH – Incremental Optimism, Structural Pessimism

**USD/CNH** – Q1 2024: 7.20 | Q2 2024: 7.25

Chinese markets are still grappling with investor pessimism. The surprise RRR cut (announced on January 24th) helped boost equity sentiment, but foreign investors are still skeptical about the medium term prospects for demand recovery. Previous positive headlines – regarding a RMB 1trln “special sovereign bond” issuance for fiscal stimulus, and another headline (on January 23rd) about a RMB 1trln “stabilization fund” for mainland equities, failed to boost sentiment beyond a one-day rally.

Prior to those positive headlines, we think that the market's negative reaction to GDP was overdone – full-year 2023 GDP growth (5.2%) still exceeded the official target of 5%. However the reaction confirmed the market was fatigued with incremental easing measures and is looking for meaningful policies. The RRR cut is a positive development, but in our view it is not a signal for “flood style” stimulus. For pessimists, the Chinese government is either unwilling or unable to revive moribund domestic demand.

USD/CNH briefly traded above 7.20 and towards our Q2 forecast of 7.25, albeit faster than we expected. We think US-China tensions are adding to negative China sentiment, while recent USD/CNH momentum was also being driven by Fed re-pricing. In our view, USD/CNH will peak near 7.25. Almost every week media reports that state banks are selling USD in the spot market to defend the onshore yuan. Thereafter we expect very slight downside relief to 7.20 and 7.15 in Q3 and Q4, respectively. The yuan will benefit from USD weakness, but less so than North Asian peers JPY and KRW.

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