CIBC FICC Strategy and Economics

FX MONTHLY

July 2024

Inflation and Politics in Focus Into H2

Key Points

- **USD**: We see small upside risks to the USD as global growth starts to slow. Flareups of political risk could add additional risks for further USD upside, though we suspect the move would be contained as US data starts to soften and as we approach the expected start of the Fed's easing cycle.
- **CAD**: One month of higher inflation (May: 2.9%y/y vs. consensus 2.6% on headline) is not enough to revise our July call which continues to look for a cut. However, we are less convicted than before and will wait for the upcoming CPI print for further clarity.
- **EUR:** Political uncertainty around the French elections have caused real money investors to pare back on EUR longs. Ultimately, we believe a more protracted EUR selloff remains unlikely unless 1) either of the French political extremes gain an absolute majority in the European Parliament, or 2) President Macron unexpectedly resigns. These are both very low probability outcomes in our view.
- **GBP:** Our forecasts for an August cut from the BoE is only partially priced (~55%) which leaves some room for GBP/USD weakness. The upcoming election on July 4th should have minimal impact on the sterling.
- **AUD and NZD:** An upside surprise in Australia CPI (+4.0% y/y vs consensus +3.8%) has led the market to reprice the possibility of RBA hikes. We ultimately believe it is too soon for the RBA to respond, and June CPI data and Q2 CPI (due July 31st) will be more important. Our Q3 target for AUD/USD stands at 0.65, on the market paring back rate hikes. We expect NZD/USD to be roughly rangebound through Q3, given the balance of weak growth but an unrelenting RBNZ.
- **MXN:** We are revising our Q3 forecast slightly upward to 18.50 (prev. 18.20) to reflect our expectations of an earlier start of the easing cycle. That said, we recognize that the pair will remain prone to quick, albeit brief, spikes towards the 19.00-19.20 range, as constitutional reform discussions begin in Q3 and the US Presidential election race heats up.
- **CNH:** Declines in infrastructure spending in April and May have been concerning for the yuan given that infrastructure investment has been a key contributor towards the 5% growth target amid property weakness. USD/CNY fix continues to trend higher, and we are looking for USD/CNH to grind towards 7.35 in Q3.

FX Forecasts

End of period:	Jul 2, 2024	Q3 '24	Q4 '24	Q1 '25	Q2 '25	Q3 '25	Q4 '25
USD / CAD	1.37	1.39	1.38	1.36	1.35	1.35	1.34
EUR / USD	1.07	1.08	1.08	1.09	1.10	1.11	1.12
USD / JPY	162	157	153	150	147	146	145
GBP / USD	1.27	1.27	1.27	1.28	1.28	1.31	1.31
USD / CHF	0.90	0.92	0.93	0.93	0.93	0.92	0.92
USD / SEK	10.64	10.37	10.19	10.00	9.82	9.64	9.51
AUD / USD	0.67	0.67	0.68	0.68	0.69	0.69	0.70
NZD / USD	0.61	0.61	0.61	0.62	0.62	0.63	0.63
USD / NOK	10.72	10.47	10.19	10.00	9.82	9.59	9.38
USD / ZAR	18.60	17.95	17.65	17.25	16.95	16.80	16.66
USD / BRL	5.67	5.50	5.20	5.20	5.20	5.00	5.00
USD / MXN	18.25	18.50	18.00	17.50	17.80	17.80	17.50
USD / COP	4135	4100	4100	4000	3950	3950	4000
USD / CLP	947	900	880	860	820	840	840
USD / CNH	7.31	7.35	7.30	7.28	7.25	7.20	7.15

CAD Crosses

End of period:	Jul 2, 2024	Q3 '24	Q4 '24	Q1 '25	Q2 '25	Q3 '25	Q4 '25
CAD / JPY	118	113	111	110	109	108	108
CAD / CHF	0.66	0.66	0.67	0.68	0.69	0.68	0.69
AUD / CAD	0.91	0.93	0.93	0.92	0.92	0.93	0.93
GBP / CAD	1.74	1.77	1.75	1.74	1.73	1.77	1.76
EUR / CAD	1.47	1.49	1.49	1.48	1.49	1.50	1.50

EUR Crosses

End of period:	Jul 2, 2024	Q3 '24	Q4 '24	Q1 '25	Q2 '25	Q3 '25	Q4 '25
EUR / JPY	173	169	165	164	162	162	162
EUR / GBP	0.85	0.85	0.85	0.85	0.86	0.85	0.85
EUR / CHF	0.97	0.99	1.00	1.01	1.02	1.02	1.03
EUR / SEK	11.41	11.15	11.01	10.90	10.80	10.70	10.65
EUR / NOK	11.50	11.26	11.01	10.90	10.80	10.64	10.51

**Green indicates a revision higher; Red indicates a revision lower*

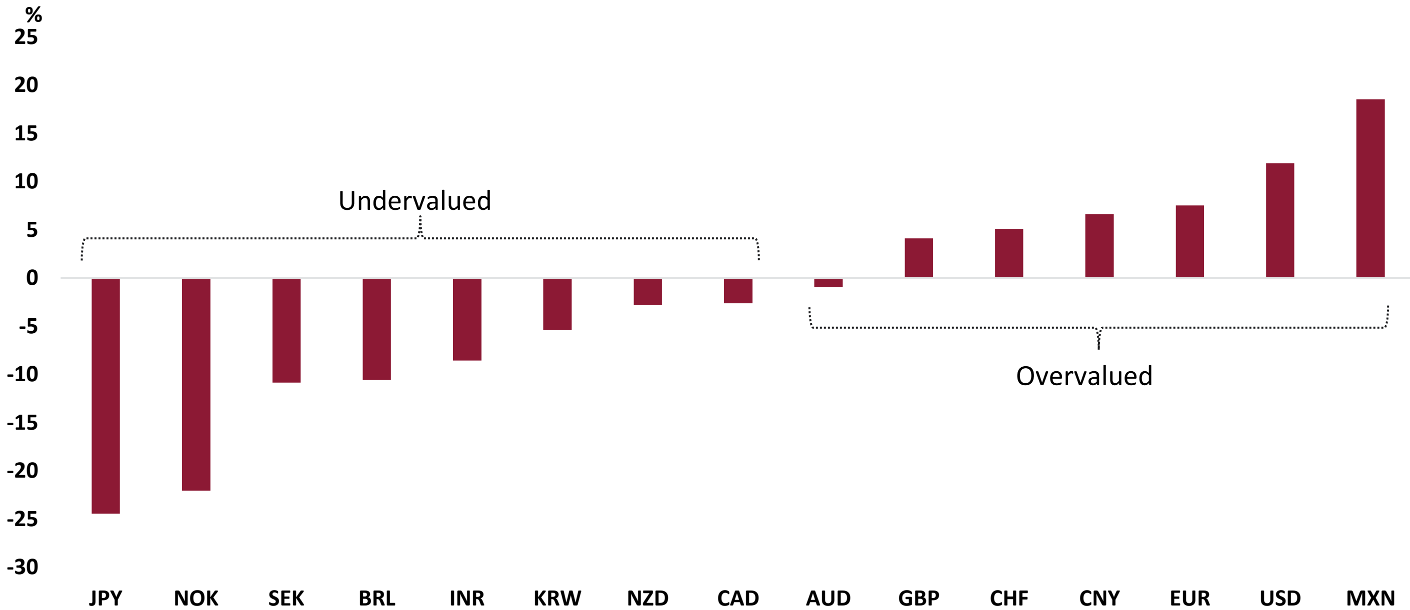
Central Bank Forecasts

	Current	Q3 '24	Q4 '24	Q1 '25	Q2 '25	Q3 '25	Q4 '25
Fed	5.38	5.13	4.88	4.38	4.13	3.88	3.63
BoC	4.75	4.50	4.00	3.50	3.25	3.00	2.75
ECB	3.75	3.50	3.25	3.00	2.75	2.50	2.25
BoE	5.25	5.00	4.50	4.25	4.00	3.75	3.50
SNB	1.25	1.00	1.00	1.00	1.00	1.00	1.00
BoJ	0.10	0.10	0.10	0.25	0.25	0.25	0.25
RBA	4.35	4.35	4.10	3.85	3.60	3.60	3.60
RBNZ	5.50	5.50	5.25	5.00	4.75	4.50	4.50
Banxico	11.00	11.00	10.50	10.00	9.50	9.00	8.50
BCB	10.50	10.25	10.25	10.25	10.50	10.50	10.50
BCCh	5.75	5.25	5.00	5.00	4.75	4.50	4.50
Banrep	11.75	9.50	8.50	7.50	7.50	7.25	7.00

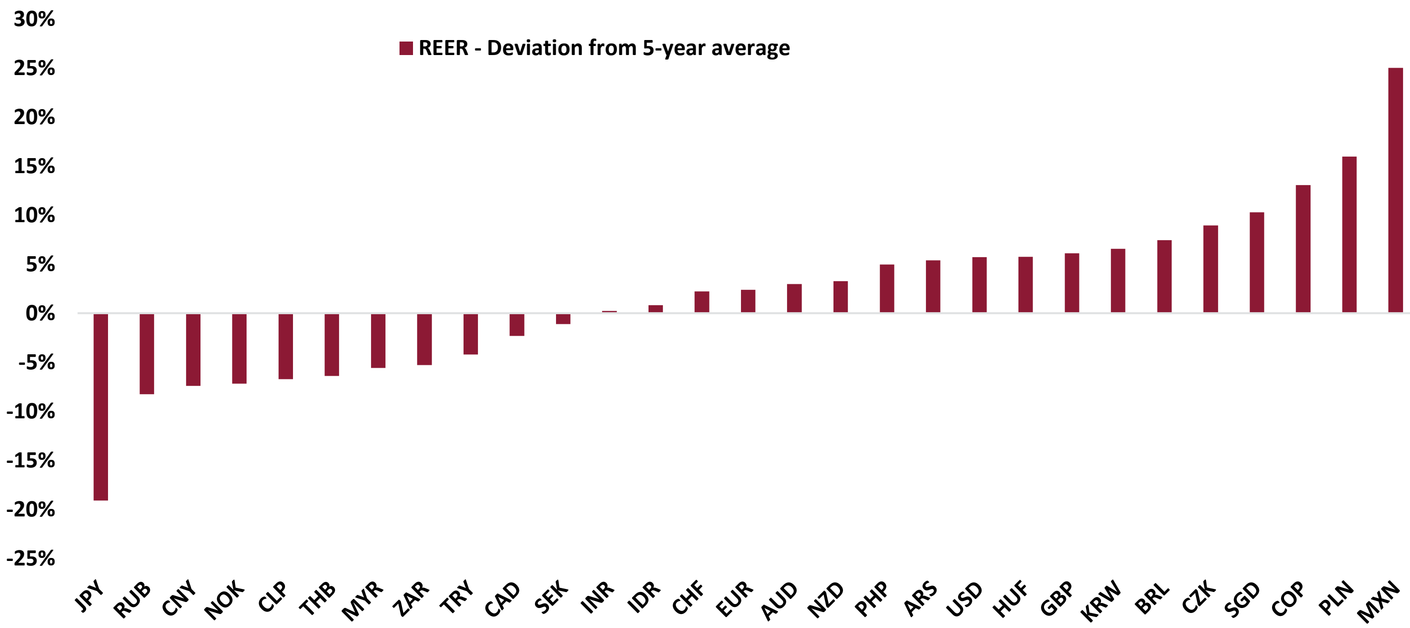
Market Pricing

	Current	Next Meeting	Q3 '24	Q4 '24
BoC	4.75%	Jul 24	4.54%	4.32%
Fed	5.38%	Jul 31	5.15%	4.86%
ECB	3.75%	Jul 18	3.47%	3.25%
BoE	5.25%	Aug 1	4.98%	4.76%
RBA	4.35%	Aug 6	4.44%	4.46%
RBNZ	5.50%	Jul 9	5.36%	5.14%
SNB	1.25%	Sep 26	1.07%	0.98%

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.

United States

Sarah Ying and Noah Buffam

USD – A Long Awaited Normalization

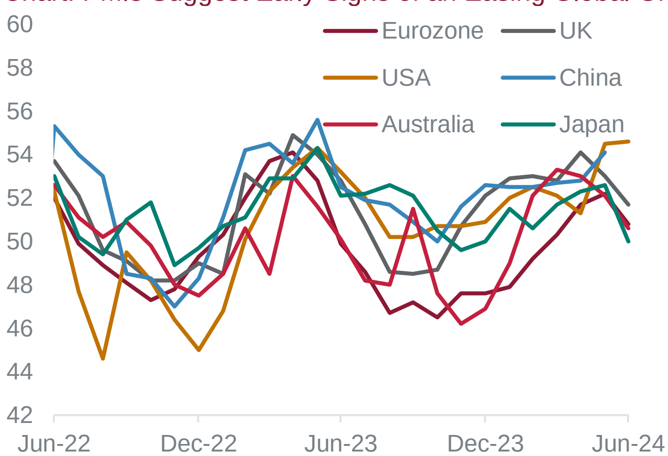
DXY – Q3 2024: 105.39 **|** Q4 2024: 104.63

Through the month of June, the US economy displayed further signs of moderation, as restrictive policy rates appear to finally be weighting on spending. However, even with the continued normalization in the economy, the DXY managed to gain over the month, as French political risks led to a bid for havens. Moving into Q3 we're expecting USD pairs to be driven by a mix of easing global growth pushing USDs higher, partially offset by any country-specific inflation surprises that may arise (especially in Australia and Canada after outperformance in May). As such, we expect the broad USD to be generally rangebound, although flare-ups of political risk could lead to pockets of USD upside.

Momentum in the US economy continued to ease in June, with the data flow generally on the weaker side of consensus. May CPI came in soft, and while it was in part driven by a decline in volatile elements, there was also a broader easing in core services. Consumer spending also disappointed, with retail sales flat in level terms through Q2. Nonfarm payrolls was one of the sole bright spots, but importantly, most forward looking measures of labour demand suggest a looser labour market is ahead. Altogether, this points to easing slack in the US economy. While the Fed's updated dot plot showed the median governor expecting one cut this year, the market is looking for more with expectations stabilizing at 2 cuts this year. Our forecasts are looking for two cuts from the Fed – in September and December – especially as the US economy is beginning to show signs of slack.

While we expect a global soft landing, we see growth bottoming in Q3, before picking up again into 2025. The recent roll over in global PMIs suggest that this trend may be beginning (Chart below), as most DM rates have been restrictive for about a year and a half. A continued easing in the growth profile could lead to some pockets of USD strength in the back half of the year. However, as we move into 2025, our expectation is that the broad USD will depreciate as global growth picks back up amid a global easing cycle.

Chart: PMIs Suggest Early Signs of an Easing Global Growth Profile



Source: S&P Global, CIBC Capital Markets

Canada

Avery Shenfeld and Katherine Judge

CAD – Navigating Data Dependency

USD/CAD – Q3 2024: 1.39 **|** Q4 2024: 1.38

Canada's CPI picked up in May, but that one month blip still left annual inflation sitting below the Bank of Canada's April forecast. The three-month trend also remained relatively benign, as the May print followed a few lower readings. If, as we expect, June's core CPI measures run at a 0.2% monthly pace, the Bank of Canada is likely to remain on track for a July rate cut, with two further quarter point cuts in the final quarter of the year. There's obviously some risk that a second firmer inflation reading pushes back the timetable for the next easing until September, but we see enough broad disinflationary pressures in play, including increased labour market slack and mediocre domestic demand, to give us confidence that the general direction for inflation is still favourable. Note that excluding mortgage interest, the one item that has been directly pushed higher by pervious rate hikes, Canada's CPI has run below the 2% target over the past year.

For the currency, all this means is that the market is pricing in too few cuts for the Bank of Canada this year (~50 bps more after the June cut, versus our call for a further 75bps), as opposed to in the US, where the market is roughly in line with our expectation for the Fed to ease twice before year end. A July rate cut by the Bank could see USD/CAD near our Q3 target of 1.39. Thereafter, any strengthening in the C$ that we expect would be driven largely by broad USD softness, with the greenback starting from an overvalued position against other majors on trade fundamentals, and likely losing the some of its earlier flight-to-safety gains as a global easing in monetary policy raises hopes for better global activity in 2025. That lift to global growth next year would also be a boon to Canadian resource exporters, and could see USD/CAD reach 1.34 by the end of 2025.

Europe

Jeremy Stretch

EUR – Trading Political Risk

EUR/USD – Q3 2024: 1.08 | Q4 2024: 1.08

Real money investors have aggressively pared EUR longs over recent positioning snapshots. The correction comes against the backdrop of renewed political risk, centred on France, allied to a rolling over in forward looking sentiment. In terms of forward survey indicators, German manufacturing sentiment materially undershot expectations in June. Rather than a 1-point gain the series witnessed its second worst performance in the last 12 months. Moreover, German business expectations (Ifo) witnessed the most aggressive monthly correction in 12 months. Although German investor expectations (ZEW) maintained an upward trajectory, (sentiment has advanced for 11 snapshots), the series having undershot expectations, underlines a macro rationale for unwinding EUR holdings.

However, it's the return of EUR political risk for the first time since 2016/17 that has undermined EUR sentiment. European Parliament elections have a long history of being regarded as protest votes, hence success for far-right parties was not necessarily unexpected. However, the decision by the French President to call a snap Parliamentary election, with the next scheduled poll not until after the next Presidential election in 2027, has resulted in OAT-Bund spreads widening to extremes not witnessed since 2012. Although the French political stakes are high, we are not yet anticipating an existential euro crisis, in the context of either 2011/12 or 2016/17, that is unless either of the French political extremes, gain an absolute majority in the 589 seat Parliament.

Cohabitation between President and Parliament, namely that they are of different political persuasions, is not unique. A fractious and disunited Parliament risks a protracted period of French political paralysis. While a EUR negative, this does not necessarily imply a correction towards 1.05. While we can expect investors to move into defensive EUR positions, we remain sanguine regarding immediate risks absent an extreme political grouping gaining an absolute Parliamentary majority or President Macron unexpectedly resigning. We would regard both as low probability outcomes. Hence we view near term EUR downside as remaining contained.

GBP – Policy Remains "Finely Balanced"

GBP/USD – Q3 2024: 1.27 | Q4 2024: 1.27

The BoE maintained an unchanged policy stance for a seventh straight meeting, again by a 7:2 margin, at their June meeting. For now, the BoE requires more evidence to support the notion of an unwind in inflation persistence. Although headline CPI retreated to the 2% target threshold in May, some MPC members viewed the return of headline inflation to 2%, as not necessarily indicative of a "sustained return to target." However, for some of those who voted for no change the decision to maintain policy was "finely balanced". The underlying policy narrative leaves us still comfortable looking for an August policy adjustment; the next decision includes both updated forecasts and a post-decision press briefing. The impact of the latter is likely to be more pronounced in the wake of the Bank having been in a period of political policy purdah.

The bank pushed back against the notion of their June decision being impacted by the snap election. In this context we would note that service sector CPI in May remained sticky at 5.7%, well above levels consistent with the CPI target. However, we would note that flash service sector sentiment is on the retreat, this helps support our reticence to extrapolate Q1 consumption impetus. The moderation in the services PMI appears at least partly attributable to the snap election. However, we would note that the divergence between the UK government bond performance and CDS underlines a lack of market concern regarding the election outcome. Indeed given that Labour has had a consistent opinion poll lead of around 20 points, the market appears braced for a period of relative political stability, for the first time since 2015.

Despite politics not likely impacting Sterling we remain biased towards near term GBP headwinds. We expect excess real money longs to continue to be pared as the market is forced to correct what we would regard as underpricing (-16bps) into the 1 August BoE policy decision.

CHF – Two Cuts and Counting

EUR/CHF – Q3 2024: 0.99 **|** Q4 2024: 1.00

Market expectations regarding a second cut ebbed into the policy decision as headline annual prices remained stuck at the highs of the year, (1.4%) in May. However, a further downward adjustment in the bank's inflation profile, we witnessed a similar move alongside March's surprise cut, supported a second 25bps adjustment, taking the rate 1.25%. We head towards the final policy meeting (September) of Thomas Jordan's tenure at the SNB with the market pricing in almost 16bps of easing.

The market is discounting the target rate ending the year at 1.00%, in line with our long term base case. Despite current inflation remaining at the highest level since December, the central bank has further revised down its CPI profile. Although CPI is expected to grind higher into Q3, to 1.5%, CPI is set to remain below the 2% threshold across the forecast profile. Indeed long run SNB estimations, to Q1 2027, have been trimmed to 1.0%. Price pressures remaining well below target points towards outgoing central bank governor acting in September, easing the immediate burden on his successor, SNB insider and current vice President Schelegel.

The inflation profile downgrade is a function of recent CHF gains. In terms of the currency we would note that during Q1 the SNB largely refrained from intervention. The bank stood back as the market cheapened the CHF, boosting competitiveness and encouraging imported inflationary pressures. The abstinence of CHF selling comes in the wake of the bank selling CHF100bn in the previous three quarters. Recent safe-haven inspired CHF gains, supports the prospect of renewed interest to cheapen the currency via both conventional and unconventional means.

SEK – Disinflationary Confidence

EUR/SEK – Q3 2024: 11.15 **|** Q4 2024: 11.01

After cutting rates at the May policy meeting (to 3.75%) there was little expectation of a second policy adjustment at the June policy meeting. However, the rate path implied by the central bank underlines that a further 25bps policy adjustment at the August policy meeting remains a realistic probability. The Riksbank remains confident regarding the disinflationary process despite May CPIF coming in above expectations at 2.3%. Central bank Governor Thedeen remains intent on allowing the data to determine whether the bank will act on 20 August or wait until the 25 September meeting. We favour the former, with further action coming in November.

Although the downtrend in CPIF proved to stall in May, prices are set to remain on a downward trajectory into H2. The expectation of ongoing disinflationary dynamics supports the prospect of a further 50bps of easing in 2024 ahead of rates moving towards neutral, assumed to be around 2.50%, in 2025.

Although we have witnessed a recent bounce in EUR/SEK we would expect the move to prove temporary, not least as we continue to anticipate a stronger global growth narrative in 2025, the small open Swedish economy remains highly cyclically correlated. In terms of domestic macro dynamics we remain mindful of the correlation between SEK performance and the economic tendency survey. The latest survey has witnessed a fourth gain in the calendar year resulting in the series reaching levels not witnessed since August 2022. A ninth straight gain in consumer confidence, (marking the longest run on record with data going back to 1993) supports a graduated recovery narrative, underpinning a constructive long run SEK bias.

NOK – Norges Remains the Laggard

EUR/NOK – Q3 2024: 11.26 **|** Q4 2024: 11.01

While markets continue to debate global monetary reversal, remember three key European central banks, the ECB, Riksbank and SNB have already eased, (the latter twice) the Norges Bank continues to maintain a broadly restrictive policy bias. Indeed not only did the central bank unanimously hold rates at 4.50%, at their June policy meeting they also maintained a higher for longer bias via a policy statement which underlined that rates will remain at peak levels "for some time ahead". Underlining central bank reticence regarding early policy easing comes via the bank underlining that an early policy adjustment would risk inflation remaining above target for too long.

Norges Bank policy guidance clearly implies that rates are likely to remain at current levels until the end of the year, the market is currently only pricing around 9bps of easing by year-end. The presumption of an extended period of policy inertia comes against the backdrop of a graduated uptick in the economic surprise index, from six month lows witnessed back in May. Contingent to the uptick is a strong rebound in the regional economic tendency survey, the current quarter advanced from -0.1% to 0.2% while the outlook for the next quarter (0.3%) has not been exceeded since Q1 2022. Although restrictive monetary policy continues to drag on credit growth, an annual rate in excess of 3% suggests that consumption growth should remain constructive when set against a tight labour market and rising real earrings. Norges bank policy reticence, combined with resilient domestic fundamentals maintain a bias towards a stronger NOK bias into H2 and beyond.

Asia-Pacific

Maximillian Lin

JPY – Staying Dovish and Retreating to 162

USD/JPY – Q3 2024: 157 **|** Q4 2024: 153

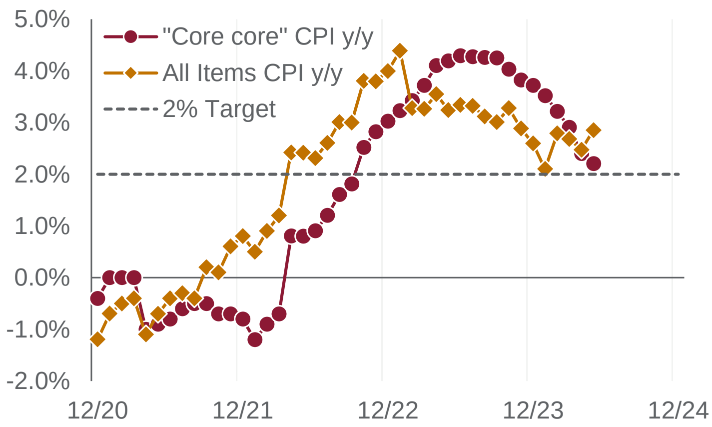
Since 2023 the BoJ has consistently disappointed the market's expectation for tightening. The June 14th policy decision was no exception – although the BoJ announced a taper of its monthly JGB purchases, the central bank was creative (and dovish) in its message; no taper details on taper amounts were included.

Instead, the BoJ announced it "will decide on a detailed plan for the reduction of its purchase amount" at the July 31st meeting. Ahead of that announcement, the BoJ will convene "Bond Market Group" meetings (July 9-10th) to consult with Japanese banks, and financial firms on taper amounts.

The vague message confirms yet again that the BoJ is unconcerned with yen weakness. The Ministry of Finance (which intervenes to stabilize yen) has different priorities than the BoJ (which is focused on inflation). That points to another dovish July BoJ. We expect no rate hike for the July meeting; the June decision confirms that the BoJ does not want to be seen as doing "too much too quickly," especially when "core core" CPI is declining (see chart).

USD/JPY rose past the key 160 level in late June, and the pair is very close to our Q2 end target of 162. We still think the yen can weaken to this level in July. Much like the prior "red lines" at 152 and 155, we think the MoF has "surrendered" the 160 level amid carry outflows. 165 is the next "red line" for authorities; the MoF could step up defenses at 162 (ahead of 165) in July, but if US data remains strong, upward momentum in USD/JPY will persist. For end Q3, we expect a yen rebound to 157 once the Fed cuts.

Chart: "Core core" CPI, Which Excludes Energy and Fresh Food, is Declining



Source: Bloomberg, CIBC Capital Markets

AUD – The RBA Won't Get Carried Away

AUD/USD – Q3 2024: 0.67 **|** Q4 2024: 0.68

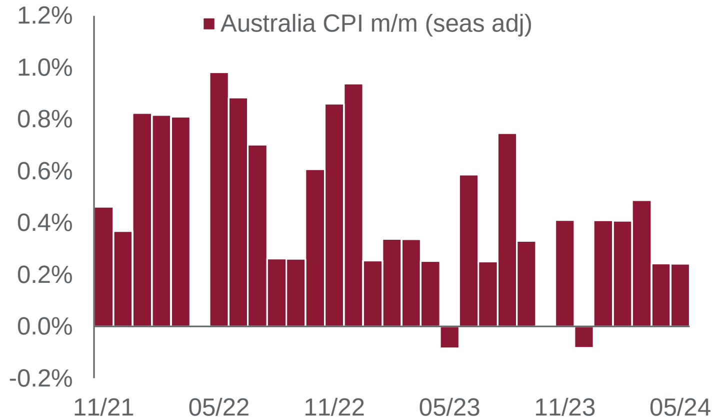
May CPI surprised to the upside (+4.0% y/y vs consensus +3.8%), leading to markets to re-price the chances of further RBA hikes. December RBA OIS pricing rose by 16bps to 4.50%, or a 68% chance of 2024 hike. Some forecasters even changed their view for the August RBA to hike.

We think it's too soon to declare the RBA will hike in August. June CPI data and Q2 CPI (due July 31st) will be more important for the August meeting, while June employment (due July 18th) will also be key. A further tick higher in unemployment (currently 4.0%) could also prompt the RBA to stay neutral / patient. Furthermore, we note that the 0.2% m/m CPI gain in May is in-line with April (and down from +0.5% in March, see chart).

At the June RBA press conference, Governor Bullock noted that "the board discussed the case of a rate hike at this meeting," and that "the case for a rate cut wasn't considered." We expect similar asymmetry in August, but we do not think the August RBA decision will be "live," a large majority of MPC members will likely lean towards no change.

The RBA will remain data-dependent as it navigates "the narrow path," of a soft landing. We think that an RBA cut by the November meeting (after the Fed) makes sense. However strength in services points to risks that cuts are deferred until 2025. A patient RBA that is mildly hawkish but leaves rates unchanged should keep AUD steady in July-August, while a Fed cut in September should provide AUD a boost by end Q3. We revise our AUD/USD Q3 forecast to 0.67 (from 0.65 previously).

Chart: May CPI Surprised Higher, but Matched the 0.2% m/m Rate in April



Source: Bloomberg, CIBC Capital Markets

NZD – Growth is Weak, But Two-Way Risks to Inflation Persists

NZD/USD – Q3 2024: 0.61 | Q4 2024: 0.61

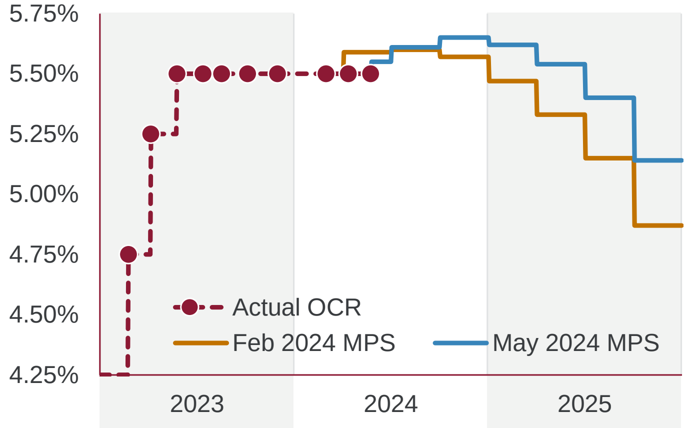
New Zealand's Q1 GDP data (released on June 20th) surprised higher, showing Q1 growth of +0.2% q/q (vs consensus +0.1% q/q). Although the Q1 growth formally signals the end of New Zealand's technical recession (Q3 and Q4 2023 showed growth of -0.3% q/q and -0.1% q/q, respectively), the overall tepid growth rate (around +0.8% annualized) is nothing to get excited about.

The slow GDP growth confirms that restrictive monetary policy is working and further RBNZ hikes are unlikely. However, the May MPS forecasts pushed back the timing of cuts (see chart). We still think the RBNZ will remain patient and wait until the November 27th meeting (in-line with OIS pricing), or possibly until February 2025.

The RBNZ's constructive tone in May and mildly hawkish forecasts affirm our existing view that the RBNZ will remain patient and take a "wait and see" approach. Immigration is contributing to high rental and housing CPI, but is likely helping to alleviate labour market tightness, which should ease wage pressures. The budget deficit implies inflationary risks, but it also highlighted the government's pessimism on GDP growth.

The July 10th RBNZ meeting will likely be inconsequential, and we expect no change. Instead the August 14th RBNZ meeting will be much more important, with an updated set of MPS forecasts. Q2 CPI data (due July 17th) and Q2 employment (August 7th) will also be released after the July RBNZ. Given the RBNZ will likely remain on hold until after the Fed, we think the kiwi will remain stable in July-August. A September Fed cut should provide an additional boost by end Q3, and we revise our forecast NZD/USD to 0.61 by Q3 (from 0.60).

Chart: The May MPS Pushed Back the Timing of Forecasted Rate Cuts



Source: Bloomberg, CIBC Capital Markets

CNH – Sentiment Remains Weak; the "Red Line" Has Shifted to 7.35

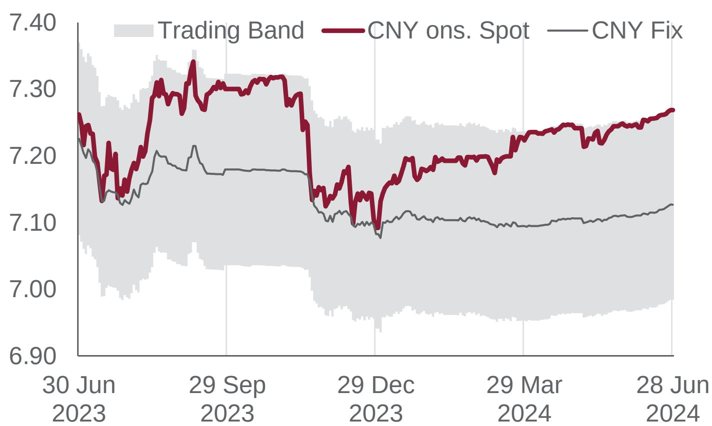
USD/CNH – Q3 2024: 7.35 | Q4 2024: 7.30

May exports and retail sales surprised to the upside (albeit with weak overall growth), but the April and May declines in infrastructure investment were more concerning. After applying seasonal adjustments, we calculate April and May infrastructure investment at 3% below the March levels. We think that is concerning because 7% trend growth state-led infrastructure investment was the key piece of private-to-public "substitution" that has kept GDP growth on track towards the 5% growth target amid property weakness.

Even so, we do not expect a shift towards more aggressive easing. Proceeds from the sale of "ultra long" 30y special government bond issuance will be deployed soon, boosting infrastructure investment and growth. The government continues to selectively ease housing restrictions; commercial banks could cut the Loan Prime Rate further (5-10 bps) in Q3, but we think a PBoC policy rate cut to either the 7d reverse repo or the 1y MLF are very unlikely. Instead, the government will continue to utilize "targeted" easing measures to boost selective sectors of the property market – to build affordable housing and support first-time homebuyers – rather than broad easing or rate cuts.

The USD/CNY fix continues to trend higher, exceeding our calculation estimates on most day (towards stronger USD / weaker yuan). We think this trend will continue, given the USD/CNY onshore spot rate remains near the upper limit of the ±2% trading band (see chart). In order to allow additional "headroom" in the trading band, the PBoC is pushing the USD/CNY fix higher while also occasionally intervening (by directing state-owned banks to sell USD). As such, we think USD/CNH will continue to grind higher, up to 7.35 in Q3.

Chart: The USD/CNY Fix and Trading Band is Shifting Higher to Accommodate USD/CNY Spot



Source: Bloomberg, CIBC Capital Markets

Emerging Markets

Latin America

Luis Hurtado

MXN – Political Risks and Dovish Banxico Will Diminish the MXN's Carry Appeal into Q3

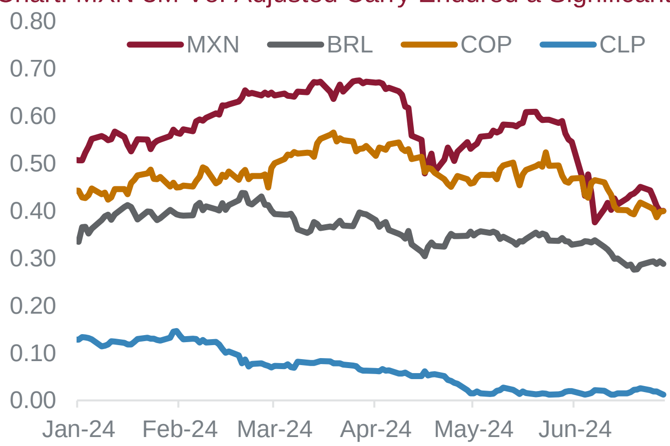
USD/MXN – Q2 2024: 18.50 | Q3 2024: 18.00

USD/MXN increased 7.1% in June, as the landslide victory of the ruling coalition in congress and President-elect Claudian Sheinbaum comments about the Judicial reform being among the first to be discussed in September were the main triggers behind the rapid unwind of long positions in the MXN. However, we highlight that there are other 'under the radar' factors that could gain relevance into H2, and that we suspect are already increasing market nervousness and volatility. These include constitutional reforms, giving preference to the CFE and banning genetically modified corn imports (negative implications for USMCA ahead of the 2026 review), threats to Chinese investment in Mexico during the US election cycle, and fiscal risks into 2025.

On the monetary policy front, Banxico kept the overnight rate at 11.00% in line with our forecast and consensus expectations. However, the decision was not unanimous with Omar Mejia voting in favour of a 25bps rate cut. Moreover, the board "foresees that the inflationary environment may allow for discussing reference rate adjustments" leaving the door open to rate cuts in Q3. It appears that the board is not excessively concerned with the recent depreciation of the MXN and has started to put more relevance on the lower than expected growth indicators. Although we still expect Banxico to cut the overnight rate by 50bps this year, we are changing the timing of the first cut to August. This will allow the CB to avoid cutting the overnight rate in the middle of constitutional reforms discussions in September, and have time to assess the market reaction before cutting again in Q4.

With regards to USD/MXN, we are revising our Q3 forecast slightly upward to 18.50 (prev. 18.20) to reflect our expectations of an earlier start of the easing cycle. That said, we recognize that the pair will remain prone to quick, albeit brief, spikes towards the 19.00-19.20 range as constitutional reforms discussions begin in Q3 and the US Presidential election race heats up.

Chart: MXN 3M Vol-Adjusted Carry Endured a Significant Correction Since the Start of June



Source: Bloomberg, CIBC Capital Markets

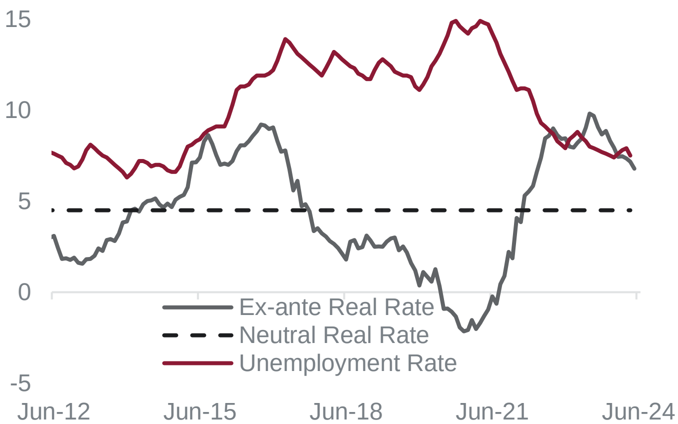
BRL – BRL Will Remain Under Pressure as Fiscal Risks Persist and President Lula Questions the CB Leadership

USD/BRL – Q2 2024: 5.50 | Q3 2024: 5.20

The Banco Central do Brasil (BCB) kept rates on hold at 10.50% in a unanimous decision in June. Despite the lack of commitment to a tightening cycle this year, we expect the hawkish BCB to be the only allied for the BRL into Q3. Note that the BCB's hawkish tone has already been confronted by government officials, exacerbating concerns about potential interference in the BCB's monetary policy by the end of the year. Moreover, fiscal risks (and volatility) will persist in the near future. The government has already used a large amount of its political capital at the very start of Lula's third mandate. Given the large concessions made to support expenses last year and in 2024, it appears we have reached a point in which further revenue measures will hit a wall in congress. This leaves a forced reduction in expenses as the main way to ensure the country meets its fiscal targets - a solution that President Lula, albeit recently suggesting some consideration, strongly opposes.

This situation has already pushed the market to price in around 70bps in rate hikes by the end of the year. We do not agree with such outlook and expect the BCB to remain on hold at 10.50% for the remainder of 2024. However, we recognize that the BCB will maintain a hawkish tone in the coming months, supporting at least some of the hikes currently priced into H2 2024. As for the BRL, we have revised our Q3 and Q4 USD/BRL forecast to 5.50 (5.20 prev.) and 5.20 (5.00 prev.), respectively, amid increased political and fiscal risks. That said, with USD/BRL breaking above 5.53 at the end of June, we do not rule out the pair chasing the 5.75 mark early in Q3.

Chart: BCB will Maintain its Restrictive Monetary Policy Stance as Labour Market's Strength Continues and Fiscal Risks Increase



Source: BCB, CIBC Capital Markets

CLP – Pause in Easing Cycle and Higher Copper Prices Wil Benefit the CLP in H2 2024

USD/CLP – Q2 2024: 900 | Q3 2024: 880

The Banco Central de Chile cut the benchmark rate by 25bps in June, further decelerating the pace of rate cuts in line with our forecast and the consensus call. The decision was not unanimous with one of the five board members voting in favour of a 50bps rate cut. The Bank recognized the upward inflationary pressures arising from the increase in electricity tariffs and higher than expected domestic demand. However, it also signaled that the easing cycle will continue within the monetary policy horizon, albeit at slower pace going forward.

The BCCh has given itself some flexibility to cut rates in the next two years (likely with pauses in the cycle) without dismissing inflationary pressures in the coming months. We reiterate our view that the market has likely overcorrected to the BCCh cautious stance pricing the terminal rate near 5.10%, above our 4.50% forecast. Regarding the peso, we see Chilean assets relatively shielded from US elections later this year, while the rate cut pauses, and the rebound in copper prices and growth also bode well for the CLP into H2 2024. We maintain our Q3 and Q4 USD/CLP forecasts at 900 and 880, respectively.

COP – Banrep Prepares Market For Larger Rate Cuts in Q3

USD/COP – Q2 2024: 4100 | Q3 2024: 4100

Increased volatility following recent political events around the world (surprising elections results in Europe, Mexico, India and South Africa) triggered a sharp depreciation of the COP as the market questioned carry trades since the start of June. Local factors such as the approval of an increase to the debt ceiling this year, and the presentation of the medium term fiscal framework also created some noise. The government forecasted a 5.6% of GDP deficit in 2024, up from 5.3% of GDP in the previous fiscal guidance. Under the revised projection, the government included a 1.7% of GDP reduction in primary expenses (matching the reduction in revenues) and a 0.3% of GDP increase in interest payments.

On the monetary policy front, similar to other CBs around the world, Banrep faces still high core services prices – a situation that has prevented it from adopting a more dovish stance so far this year. Banrep met market expectations cutting the overnight rate by 50bps in June but as in previous months the decision was not unanimous. Two out of the seven board members voted in favour of a 75bps rate cut, while another one did not attend the meeting. Moreover, during the press conference, the Minister of Finance, a voting member at Banrep's board, suggested that the CB will keep cutting rates at a pace of 50bps to 75bps in Q3. We expect USD/COP to retest the 4200-4215 range into early Q3, however, going forward with short term fiscal risks out of the way and a still attractive carry, we maintain our Q3 and Q4 forecasts at 4100.

South Africa

Jeremy Stretch

ZAR – National Unity

USD/ZAR – Q2 2024: 17.95 **|** Q3 2024: 17.65

What was in effect a referendum of thirty years of political control has resulted in the African National Congress (ANC) losing their majority. However, any fears of the party being paired with the populist Economic Freedom Fighter (EFF) have been dispelled by the ANC forming a government of national unity (GNU) alongside the market friendly Democratic Alliance (DA) and two smaller opposition parties, Inkatha Freedom Party (IFP) and Patriotic Alliance (PA). The formation of such an alliance should assuage international investor concern, not least given that draft coalition deal enshrines inclusive and sustainable growth being listed as a top priority.

Despite the formation of a national unity government residual structural challenges are set to prevail, not least on the fiscal side and or in terms of logistics, such as power generation. However, we would expect the moderation in political risk, allied to a focus on growth, being set to encourage speculative investors to rebuild ZAR long positions. The immediate post-election period witnessed speculative longs being trimmed by almost three quarters, resulting in USD/ZAR retesting the 19 threshold. We have witnessed evidence of an uptick in international investor appetite for SA bonds in the wake of the national unity coalition deal being agreed on 14 June. With domestic leading indicators pointing towards a modest recovery narrative the combination of ongoing appetite for government paper, due to yield pickup, allied to moderated political uncertainty provides a more constructive ZAR outlook into H2.

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