Economics and FICC Strategy

MONTHLY FX OUTLOOK

October 6, 2022

USD Dominance to fade next year

Currency	What's changed
USD	USD will remain supported by a hawkish Fed and a safe-haven bid in Q4, before gains are unwound next year as the Fed undershoots the market's pricing for terminal.
CAD	C$ to see modest weakening in Q4 as the Fed outguns the BoC, before gaining ground in 2023 as the USD falls out of favour.
EUR	The ECB is set to undershoot median rate hike expectations, and slower global demand will weigh on growth in the region, pressuring the euro in Q4.
GBP	A lack of fiscal credibility, and a more aggressive BoE tightening bias, which will drag on growth, underlines ongoing GBP headwinds.
JPY	UST-JGB spreads nearing extremes, and the threat of MoF action and an eventual change in policy dynamics, imply a corrective JPY bias ahead.
Commodity FX	With hiking cycles by RBA and RBNZ reaching maturity, the swing factor for the currencies is the Fed. Slower growth in China and globally are headwinds.
LATAM FX	BCB signals end of tightening cycle, while BCCh's overnight rate moves to the top of the central bank's base case scenario.
FX Asia	Ongoing USD strength has taken USD/CNY and USD/CNH above previous cycle highs. A widening in both growth and interest rate differentials in favour of the USD, looks to keep the market firm through the end of the year.

Currency outlook

End of period:	Oct 6, 2022	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24
USD / CAD	1.37	1.38	1.37	1.37	1.34	1.32	1.32	1.32	1.30	1.28
EUR / USD	0.98	0.98	1.00	1.02	1.04	1.06	1.08	1.09	1.10	1.10
USD / JPY	145	140	138	136	135	130	128	127	125	124
GBP / USD	1.12	1.09	1.11	1.12	1.14	1.17	1.20	1.21	1.23	1.23
USD / CHF	0.99	0.96	0.97	0.98	0.98	0.97	0.96	0.95	0.95	0.96
USD / SEK	11.08	10.82	10.50	10.25	10.00	9.72	9.54	9.42	9.32	9.32
AUD / USD	0.64	0.63	0.64	0.64	0.64	0.65	0.66	0.67	0.68	0.69
NZD / USD	0.57	0.56	0.57	0.57	0.57	0.58	0.59	0.60	0.61	0.61
USD / NOK	10.64	10.40	10.20	9.95	9.71	9.43	9.17	8.99	8.82	8.73
USD / ZAR	17.89	18.00	17.90	17.80	17.50	17.25	17.00	16.80	16.70	16.50
USD / BRL	5.2	5.7	5.9	5.7	5.5	5.3	5.5	5.5	5.7	6.0
USD / MXN	20.1	21.5	21.0	21.5	21.3	21.5	21.5	22.0	22.5	22.5
USD / COP	4646	4600	4600	4400	4200	4200	4400	4500	4700	4800
USD / CLP	944	980	940	900	900	880	860	880	880	880
USD / CNY	7.12	7.10	7.10	7.00	7.00	6.90	6.90	6.85	6.85	6.80
USD / KRW	1403	1420	1410	1400	1400	1390	1385	1380	1375	1370
USD / INR	81.9	82.0	82.0	81.0	81.0	80.5	80.5	80.0	79.5	79.0
USD / SGD	1.43	1.43	1.43	1.43	1.43	1.43	1.43	1.42	1.42	1.42
USD / TWD	31.5	32.0	32.0	31.8	31.6	31.4	31.1	29.9	29.8	29.6
USD / MYR	4.64	4.70	4.70	4.65	4.65	4.55	4.55	4.50	4.45	4.40
USD / IDR	15188	15450	15350	15350	14800	14300	14300	14250	14250	14200

Other crosses

End of period:	Oct 6, 2022	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24
CADJPY	105.7	101.4	100.7	99.3	100.7	98.5	97.0	96.2	96.2	96.9
AUDCAD	0.88	0.86	0.87	0.88	0.86	0.86	0.87	0.88	0.88	0.88
GBPCAD	1.54	1.50	1.52	1.53	1.53	1.54	1.58	1.60	1.60	1.57
EURCAD	1.35	1.35	1.37	1.40	1.39	1.40	1.43	1.44	1.43	1.41
EURJPY	142	137	138	139	140	138	138	138	138	136
EURGBP	0.87	0.90	0.90	0.91	0.91	0.91	0.90	0.90	0.89	0.89
EURCHF	0.97	0.94	0.97	1.00	1.02	1.03	1.04	1.04	1.05	1.06
EURSEK	10.89	10.60	10.50	10.46	10.40	10.30	10.30	10.27	10.25	10.25
EURNOK	10.45	10.19	10.20	10.15	10.10	10.00	9.90	9.80	9.70	9.60

Key indicators – Latest data point

End of period:	Quarterly real GDP (y/y %)	CPI (y/y %)	Current acct (% of GDP)	Central bank rate (%)
US	1.8	8.3	-4.0	3.125
Canada	4.6	7.0	0.4	3.250
Eurozone	4.1	10.0	0.9	0.750
Japan	1.6	3.0	1.8	-0.100
UK	4.4	9.9	-4.3	2.250
Switzerland	2.8	3.5	7.9	0.500
Sweden	3.8	9.8	3.8	1.750
Australia	3.6	6.1	2.3	2.600
New Zealand	0.4	7.3	-7.7	3.500
Norway	4.7	6.5	21.5	2.250
South Africa	0.2	7.6	1.7	6.250
Brazil	3.2	8.7	-1.4	13.750
Mexico	2.0	8.7	-0.6	9.250
Colombia	12.6	11.4	-6.1	10.000
Chile	5.4	14.1	-8.5	10.750
China	0.4	2.5	2.0	2.000
South Korea	2.9	5.7	4.3	2.500
India	13.5	7.0	-2.1	5.900
Singapore	4.4	7.5	19.8	n/a
Taiwan	3.1	2.7	14.5	1.625
Malaysia	8.9	4.7	2.1	2.500
Indonesia	5.4	6.0	0.9	4.250

CAD

Katherine Judge and Avery Shenfeld

CAD to weaken, before following the pack stronger in 2023

Q4 2022: 1.38 | Q1 2023: 1.37 (USDCAD)

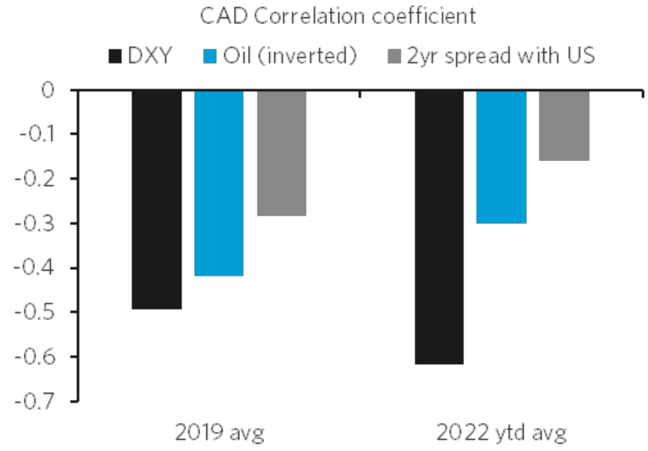
The story for the Canadian dollar has been largely told elsewhere, and that will continue to be the case as CAD movements are largely guided by the general direction of major currencies against the US dollar. The Fed's hawkish announcement in late September and general risk aversion has sent the USD on a broadly stronger trajectory, and the loonie has depreciated as a result. There's likely more of the same to come, given a gap opening up in where policy rates will peak, and soft global growth favouring the USD and capping any upside for commodities. A run to 1.40 is quite possible, and a rebound at year end should still see CAD in 1.38 territory.

Another Bank of Canada rate hike is all but certain for October, with a likely 50 bp move taking the overnight rate to 3.75%. But the Bank has seen some signs of slowing, and knows that the lagged effects of higher rates are still to come. That opens the door to a BoC pause in December if, as we expect, the data in upcoming months remains sluggish and core inflation eases a bit. A failure to press on to 4% would put some pressure on the loonie, particularly with the Fed still hiking in December, but a gap in policy rates makes sense given the greater sensitivity of debt-burdened Canadian households to higher interest rates.

While the Bank of Canada will take notice of the weakness in the loonie and its impact in raising import prices, if the USD gives up some ground next year as we expect, that impact will be short lived. In 2023, we see scope for a broad softening in the USD as the Fed pauses hiking below current market expectations, which will see CAD end the year stronger, with USDCAD at 1.32.

With the Bank of Canada likely gearing up to start cutting rates towards neutral in early 2024, the CAD could come under some temporary pressure, but the overriding factor will be when the Fed is seen as having ceased hiking, and in 2024, begins to ease. The sensitivity of the currency to broad USD moves has proven more substantial than the Canada-US rate differential recently (Chart), so the loonie could still end 2024 stronger, with USDCAD at 1.28, helped by expectations for a pickup in global growth and commodity prices in 2025 that would benefit Canada's export sector.

Chart 1: USD (i.e. DXY) is the main driver of CAD movements



Source: Bloomberg, CIBC

USD

Bipan Rai

USD to remain supported by hawkish Fed in Q4

Q4 2022: 111.8 | Q1 2023: 109.9 (DXY)

For the greenback, a mix of endogenous and exogenous drivers have provided support over the last month. For the former, the recent spate of data – especially inflation - clearly suggests there's more work for the Fed to do. As such, the Fed continues to distance itself from the 'soft landing' narrative, while markets revise estimates for the terminal rate higher. For the latter, misplaced fiscal policy out of the UK has triggered investor concerns with external imbalances and driven a 'safe haven' bid in FX markets. That's meant a stronger USD.

Regular readers are aware that we've been USD bulls for a few quarters now. That's served us well so far, and we see little reason to deviate at this point. Indeed, we still see a sufficient degree of uncertainty with respect to where the Fed terminal is priced to keep the greenback supported on dips against other major developed market currencies. That's especially true given the spate of recent data that still flags decent growth and sticky inflation in the US.

Also, a weaker backdrop for global demand should continue to buttress the USD via the safe -haven channel. That should show up against the commodity and select EM currency blocs that have been relatively sheltered against hitherto USD strength compared to the funders (like the EUR, and JPY).

Next year, we expect market narratives to shift towards an ex-US recovery. But that's a story for another time.

EUR

Jeremy Stretch

Further weakness for euro ahead as ECB set to undershoot market expectations

Q4 2022: 0.98 | Q1 2023: 1.00 (EURUSD)

We can expect the battle between the ECB Governing Council hawks and doves to continue into the 27 October meeting. The hawks are unsurprisingly concerned by headline euro HICP reaching 10% for the first time in September. Beyond headline prices, core CPI advanced for a third straight month to 4.8%. However, while price pressures continue to advance, it is notable that broad inflation expectations, as proxied by the EUR 5y5y inflation swap, remain close to the target threshold at 2.10%, compared to the cyclical highs that were just shy of 2.50% back in May.

The key question beyond the current inflation spike relates to the scale of second-round price effects, namely higher wages. ECB Governing Council hawk Schnabel anticipates that wage-price spiral risks remain contained. We would expect the Schnabel narrative, allied to an ongoing pushback from Chief Economist Lane against aggressive tightening, to preclude an October hike in excess of 75bps.

The ECB appears intent on taking the deposit rate towards 2.00% into year-end. A cumulative tightening of 125bps will leave rate spreads still substantially in the favour of the US. Euro real economy headwinds, as demonstrated by German manufacturing sentiment easing back towards immediate post-pandemic extremes, underline that the ECB looks set to undershoot median rate hike expectations. Moreover, weakness in the global economy will mean that trade is unlikely to benefit the eurozone until well into 2023.

While eurozone energy headwinds remain a concern, we also expect markets to remain mindful of the risk of widening BTP-Bund spreads. Thus far, the market has taken the formation of an Italian right-wing regime relatively calmly. Italy requires ongoing funds from the Next Generation EU fund. Eligibility for fund disbursement remains a function of ongoing structural reforms. Ahead of the naming of a new Finance Minister, it is assumed that Italy will not deviate from necessary structural measures. However, any political backsliding would risk further EUR headwinds.

JPY

Jeremy Stretch

With rate differentials nearing extremes, the yen could gain ground ahead

Q4 2022: 140 | Q1 2023: 138 (USDJPY)

Although the Japanese authorities acted to support the JPY via intervention for the first time since 1998, we regard the move as merely slowing, rather than reversing, the immediate JPY trend. The root cause of ongoing JPY weakness remains the disconnect between Japanese monetary policy and that elsewhere. Although headline CPI reached 3.0% for the first time in over three decades, the BoJ, under current Governor Kuroda, continues to view powerful monetary easing as appropriate. It hopes that by keeping policy easy, they can turn the current cost-pull inflation into a more lasting demand-pull inflation and finally turn the tables on inflation undershoots. A proposed uptick in the minimum wage could eventually precipitate a scenario where the BoJ no longer considers it necessary to maintain an accommodative stance.

The widening disconnect between the BoJ and the Fed underpinned the MoF taking “bold action.” However, as the BoJ look set to attempt to maintain Yield Curve Control, limiting 10-year yields to their current 10-year threshold (0.25%), FX intervention merely moderates near-term JPY weakness rather than being an explicit attempt to turn the tide. We expect YCC to remain in place until Kuroda steps down from the BoJ at the end of Q1, If so, unilateral intervention, without an adjustment to the root causes of JPY weakness, is almost doomed to fail.

Consequently, the MoF will merely slow the JPY slide until USD impetus wanes or Japanese trade dynamics reverse. Contained oil prices might help the latter. But we'll need a broader turn in the USD, a market realization that UST-JGB spreads have peaked, and eventual change in Japanese monetary policy dynamics to turn the yen stronger in into 2023.

GBP

Jeremy Stretch

Excessive rate hikes to weigh on sterling sentiment in light of fiscal easing

Q4 2022: 1.09 | Q1 2023: 1.11 (GBPUSD)

The end of the Elizabethan era proved almost concurrent with Liz Truss becoming the Queen’s fifteenth and final Prime Minister. Truss’s ascendance to the top of British politics has resulted in a policy disrupter taking control. The immediate legacy of the structural shift in political and macro-economic leadership has been Sterling trading at all-time lows versus the USD while Gilt yields registered record intra-day yield spikes as investors reacted to the announcement of unfunded tax cuts.

The new UK administration has embarked upon an ashamed dash for growth. The Chancellor intends, via tax cuts and structural reforms, to encourage the UK trend growth rate to rebound back to pre-global financial crisis levels at around 2.5%. Note average growth since 2015 has been a modest 1.5%.

Beyond the previously announced energy support measures, the aggressive fiscal easing announced on 23 September initially equated to around £45bn, (ahead of the U-turn on taxes for higher earners). The fiscal ease remains the biggest tax-cutting event since 1972. Although the government has subsequently walked back, after extreme political pressure, plans to cut the top rate of tax from 45% for high earners, that only trims the fiscal easing by around £2bn. Investors are rightly concerned that the fiscal injection has come without independent budget scrutiny or any measures to alleviate the shortfall. The government currently does not plan to publish its medium-term fiscal strategy until 23 November.

The lack of fiscal credibility, allied to a more aggressive BoE tightening bias into 2023, dragging on growth, (the UK terminal rate is now set to be above 4%) underlines ongoing GBP headwinds. Higher rates and pressure on disposable incomes underline that 2023 GDP looks set to register a material correction, in excess of 1%. As the BoE has been forced to come in to stabilize a material dislocation in the fixed income space, we would expect that the currency will continue to be the broad pressure release valve amidst ongoing fiscal and political pressures. Hence the recent GBP rally is likely to soon stall, leaving open the risk of a re-test of 1.08 prior to year-end.

CHF

Jeremy Stretch

SNB outpacing the ECB could support CHF ahead

Q4 2022: 0.94 | Q1 2023: 0.97 (EURCHF)

The SNB has taken rates into positive territory (0.50%) for the first time in eight years in the wake of a 75bps hike at the 22 September quarterly policy meeting. In view of the bank forecasting that CPI is set to remain above target until 2024, we can expect additional policy tightening. We expect another 50bps at the 15 December meeting with the risk of additional action into Q1. Contingent to a continued hawkish bias is the fact that the SNB is now forecasting 3.0% CPI this year and 2.4% next year. Prices are only expected to ease back inside the policy threshold (1.7%) towards the end of the forecast profile in 2024.

Against the backdrop of elevated price pressures, we can expect the bank to be increasingly prepared to tolerate a stronger CHF. Over the last couple of years, we have seen the SNB look to temper CHF gains. However, in light of SNB Governor Jordan moving to suggest that the Swiss currency is no longer highly valued, the reference has been a long-term SNB policy refrain, it seems that the bank may be increasingly happy to tolerate a stronger currency. Although we are wary of extrapolating the recent material retreat on sight deposits, seen as a proxy for intervention, should the long-term uptick in sight deposits, evident since Q1 2020, prove to correct, expect this to define toleration of a higher CHF.

In the context of elevated CPI, we can expect the SNB to remain wary of elevated price pressures feeding through into wage demands; this comes as the unemployment rate is at a 20-year low of 2.1%. A central bank keen to bear down on wage growth and an overheated real estate market could prove to be more activist than the ECB, supporting a stronger CHF into 2023.

SEK

Jeremy Stretch

Stabilization of risk sentiment should support SEK ahead

Q4 2022: 10.60 | Q1 2023: 10.50 (EURSEK)

The high beta status of the Swedish Krona, namely it underperforms in periods of risk negativity, has continued to haunt the SEK valuations of late. Despite the central bank accelerating the pace of tightening, surprising the market at the most recent policy meeting via a 100bps hike, the currency has broadly continued to struggle. Indeed not only did the central bank prove to act more decisively, taking their policy rate to 1.75%, near the top of the 2011 rate cycle, the bank also upgraded its terminal rate estimate to 2.50%. Expect a 50bps hike in November and a final 25bps at the February meeting.

Persistent upside inflation surprises, CPIF reached 9.0% in August, a year ago the central bank’s preferred inflation rate was barely above target at a mere 2.4%, allied to the monetary policy report upgrading the CPI peak to around 10%, up from 8% in June provides good reason for the market to price in another sizeable Riksbank rate hike next month. The bank remains concerned over inflationary expectations becoming ingrained, this comes as the Prospera inflation expectations survey, looking one year ahead, jumped from 4.4% to 5.4% in September.

While the SEK remains at risk in terms of additional risk negativity, an additional concern for investors into Sweden relates to the impact of soaring prices on household incomes. The presumption of additional tightening potentially puts the already fragile housing market under additional threat. Indeed in light of the central bank assumptions of a double-digit drop in real estate prices, underlining recession risks, it's unsurprising that the SEK has remained under pressure. However, should risk sentiment prove to stabilise post the end of Q3 capitulation, we can expect the high beta status of the currency to shift towards becoming more virtuous.

Commodity FX
NOK

Jeremy Stretch

Improvement in trade position supports NOK valuations

Q4 2022: 10.19 | Q1 2023: 10.20 (EURNOK)

The Norges Bank were an early adopter of monetary tightening, as they were the first major G20 central bank to hike back in September 2021. Moreover, having taken rates from zero to the current 2.25%, they hiked by 50bps on 22 September, it seems the scope for additional tightening may soon prove limited, this comes as the bank remains on course for a 3.00% terminal rate. With only 75bps of tightening on the horizon, less than that expected from the ECB, this suggests that recent NOK underperformance, including versus the EUR, remains a residual risk. However, relative fundamentals suggest that recent EUR/NOK valuations look increasingly stretched.

We would note that recent NOK underperformance has proved at least partly a function of broad risk aversion. While the correlation between equity sentiment and the NOK has diminished from extremes seen during 2021 and early 2022, late Q3 risk negativity helped to pace a substantive cheapening in the NOK. Should markets increasingly anticipate global monetary policy tightening reaching an inflection point this should provide a more constructive NOK backdrop.

Notionally the aggressive improvement in the external trade position, the current account surplus now exceeds 20% of GDP, should prove constructive for the currency. However, the continued uptrend in central bank FX transactions on behalf of its sovereign wealth fund is proving to weigh on the NOK. Currently, NOK4.5bn is translated per day into foreign currency. Flows have more than doubled since H1, in part as energy revenues and tax receipts have exceeded government spending. Should oil prices continue to ease, despite the best efforts of OPEC+, we can expect daily NOK selling pressure to moderate, encouraging a still positive external position to support rather than drag on NOK valuations.

AUD & NZD

Patrick Bennett

Further tests of support before lows are found

Q4 2022: 0.63 | Q1 2023: 0.64 (AUDUSD)

Q4 2022: 0.56 | Q1 2023: 0.57 (NZDUSD)

Global central bank hawkishness and higher policy rates, none more significantly so than those via the actions of the US Federal Reserve, have dominated FX trading in recent times. For AUD/USD and NZD/USD, of late, there is a very strong correlation between the shifting spread between 1y1y swap rates and moves in the respective currency pairs.

Currency market moves on shifts in interest rate differentials makes intuitive sense, as capital tends to flow from a currency with lower or declining yields to one with higher or rising returns. Influence is now being exerted as the market prices a higher US terminal rate, while the pricing of RBA and RBNZ tightening cycles appear to be reaching some maturity. RBA have downshifted from 50bps increments to 25bps steps as of the October meeting, we expect another two 25bps hikes at the remaining meetings this year, taking the cash rate to 3.10%. The RBNZ meanwhile began their tightening earlier than others, and while still clearly hawkish, are also, in our view closing toward a peak, we expect that to be at 4.00%, from the current 3.50%.

While the maturing outlook for the RBA and RBNZ has been contrasting with that for the Fed, the yield advantage of AUD and NZD over the USD has slipped by around 100bps for both, from near 100bps and 120bps respectively. This has seen AUD/USD and NZD/USD weaken in tandem. Should the yield advantage erosion continue, and we believe it will in the near-term at least, we expect to see continued downside extension in AUD/USD and NZD/USD.

In determining the extent of the anticipated further downside, we also consider the fact of the high-beta or pro-cyclical nature of both the Australian and New Zealand economies. That is, while the interest rate differential will be a strong guide, both currencies face pressures as the economies face headwinds not just to domestic activity from higher policy rates, but also to slower external demand as a result of softer global growth, including importantly that sourced in China.

As some counter to any runaway weakness in both currencies, a check of the relationship of both to relevant commodity prices, including iron ore and dairy, indicates that the currencies have already softened well beyond levels suggested by previous correlations. While we advocate part of that is due to the weak global activity and demand outlook, the fact of underperformance showing already is of some note.

We highlight AUD/JPY and NZD/JPY as also having potential for downside. JPY weakness may stall, as it has done on a relative basis vs other majors since the end of 2Q, particularly now when it is aided by a real intervention threat, while AUD/USD and NZD/USD remain pressured. We recommend being sellers of strength in AUD/JPY and NZD/JPY.

ZAR

Jeremy Stretch

ZAR under pressure, highlighted by twin deficits

Q4 2022: 18.00 | Q1 2023: 17.90 (USDZAR)

The SARB has moved to push through a sixth rate hike in the current cycle. A second straight 75bps increase has resulted in rates returning to levels seen immediately ahead of the Covid crisis at 6.25%. The central bank continues to anticipate that the tighter monetary environment will prove to anchor inflation expectations, prompting CPI to head back towards its target into 2024.

Although headline CPI eased back to 7.6% in August, marking the first correction since the turn of the year, inflation expectations continue to push higher. The latest survey from the Bureau for Economic Research points towards inflation remaining at 6.5% in Q3, up from 6.0% in the previous quarter. In the light of central bank Governor Kganyago suggesting that the central bank will continue to tighten until inflation reaches the mid-point of the 3-6% inflation band, one year ahead market rate expectations have headed towards 8.50%, we have not seen such extremes seen at the end of 2015.

The presumption of significant additional tightening continues to weigh on growth assumptions and drag on broad investor sentiment. A prolonged period of above-average inflation and slow growth, additionally the current account is expected to slip back into deficit territory into 2023, underlines why speculative ZAR holdings have fallen back to levels last seen in March while international investors have been net sellers of foreign bonds over the last month. As investors remain wary of those EM nations who are running twin deficits, budget and current account, South Africa is expected to have both in 2023, underlines why the ZAR looks set to remain on the defensive at least until there are signs of a moderation in USD momentum.

LATAM FX
MXN

Luis Hurtado

Banxico increases rate by 75bps and maintains very cautious tone, but…

Q4 2022: 21.5 | Q1 2023: 21.0 (USDMXN)

Banxico increased the overnight rate by 75bps to 9.25% last week, in line with market expectations and our forecast. Moreover, Banxico revised its inflation forecast until the end of Q2 2024 higher, although stated it expected to converge to target by Q3 2024. Based on Banxico’s cautious statement and the increasingly hawkish tone from major central banks, we now expect the terminal rate to land at 10.25 and odds of rate cuts in 2023 to be priced out. In terms of the magnitude of rate increases to come, we foresee Banxico raising the overnight rate by 50bps in each of November and December. However, such a trajectory still keeps our forecast below the market’s current expectation of a Banxico terminal rate of 10.50%-10.75%.

Note that with last week’s 75bps rate increase, the ex-ante real policy rate (overnight rate – 1y inflation expectations) is now 110bps above Banxico’s neutral real rate range (1.8%-3.4%). Our belief that there is another 100bps left in the tightening cycle would put the real rate significantly into restrictive territory and well above the 2018-2019 tightening cycle, reinforcing our view of a sooner-than-later decoupling from the Fed.

Although we recognize the MXN’s attractive carry during periods of relative calm in equity markets, we maintain our strategic long USD/MXN bias to 21.00, in line with our forecast for the rest of the year. On top of our expectations of a decoupling from the Fed, we would point out that despite increasing global growth concerns and swift movements in fixed income markets, we have not experienced such extreme moves in equities, while US labour indicators continue to show signs of strength. This together with the narrative that Mexico is one of the main beneficiaries of nearshoring have allowed the MXN to outperformed major and regional currencies in 2022. However, it also highlights its exposure to sudden moves in US equities going forward.

BRL

Luis Hurtado

BCB signals end of tightening cycle

Q4 2022: 5.7 | Q1 2023: 5.9 (USDBRL)

In a split decision and in line with market expectations and our forecast, the Banco Central do Brasil decided to keep the Selic rate on hold at 13.75% - two out of the nine board members decided to vote in favour of a 25bps rate hike. We recognize that given current market dynamics (i.e. a more aggressive Fed tightening cycle, and lingering fiscal risks), the central bank is allowing some flexibility should local and external inflationary pressures persist and increase, and did not rule out further rate hikes. Nonetheless, today's communique sends a strong signal of resistance to such option, and a preference to maintain the Selic rate at current levels for a prolonged period.

In a tighter than expected result Lula led the first round presidential election with 48.4% of the votes, versus Bolsonaro's 43.2%. Notwithstanding some signals of economic pragmatism in Lula's campaign, recent PT's ally announcements (Henrique Meirelles) and right leaning parties outperforming in congress, we expect headline risk to remain high for the remainder of the campaign, with constant clashes between both candidates. Hence, despite long BRL plays driven by the currency's carry, especially during periods of relative market calmness, we expect such moves to remain brief and we maintain our upward USD/BRL bias towards 5.50.

CLP

Luis Hurtado

Hawkish CB fails to provide support to the CLP

Q4 2022: 980 | Q1 2023: 940 (USDCLP)

In a split decision (Griffith-Jones voted for a 75bps rate increase, while Alberto Naudon and Luis Felipe Cespedes voted for a 125bps rate hike), the BCCh increased the overnight rate by 100bps to 10.75%, against our 50bps forecast and the 75bps expected by BBG consensus. Moreover, although the overnight rate has already moved to the top of the base scenario in the monetary policy report, the CB left the door open for more rate hikes. Note that the market had been speculating about the possibility of large rate hike as inflation continued to surprise to the upside and USD/CLP's large intraday moves remained in place. However, despite the hawkish surprise at the start of September, the central mentioned recent negative growth and confidence numbers, suggesting limited room for a continuation of the hiking cycle beyond October. Hence, we expect the BCCh to implement another and perhaps final 50bps rate hike this month.

That being said, after testing 850 following the rejection of the new constitution and a hawkish central bank, the CLP failed to find further support and resume a steep upward trend retesting the 1000 mark in recent weeks. The depreciation of the CLP coincided with BCCh FX intervention program approaching its end, and major central banks increased their hawkish rhetoric. Despite the CLP attractive carry, we recognize that the current world dynamics (higher rate, lower growth) are likely to keep the peso under pressure in the short term and would keep our toes out of the water for now.

COP

Luis Hurtado

COP to remain under pressure

Q4 2022: 4600 | Q1 2023: 4600 (USDCOP)

Banrep increased the overnight rate by 100bps last week, below the 150bps rate hike expected by BBG consensus and our forecast. Banrep has decided to focus on the steep deceleration of growth for next year. However, we point out that the fiscal need to end the subsidies to fuel prices should continue to push inflation higher in the short term as the government start a gradual increase of prices this month and inflation continued to surprise to the upside coming in at 11.44% y/y in September. Hence, despite the dovish statement by the central bank last week, we do not expect Banrep to further slowdown the pace of rate increases in November, and see another 100bps rate increase.

Looking at USD/COP, the government position against new oil exploration and fiscal concerns suggest a slow structural depreciating trend over the next few years. Moreover, although we expect USD/COP to find significant resistance at the 4600 mark, we do not rule out the pair retesting all-time highs as the market focuses on higher global rates and global growth concerns increase.

Asia FX
CNY

Patrick Bennett

Weaker against a strong USD

Q4 2022: 7.10 | Q1 2023: 7.10 (USDCNY)

As USD/CNY and USD/CNH reached levels above 7.2000, exceeding the peaks of 2019 and 2020, an entirely valid question is raised; that of where now? We have to go back to 2008 for the last time USD/CNY traded at the same levels as currently, while USD/CNH has had no such experience, having only been established as a currency pair in 2010. The USD/CNY experience doesn't provide much insight, as the period in question was in the midst of a long-term appreciation of the yuan, with the state of the Chinese and global economies barely comparable to now.

We look to interest rate differentials for some guidance, both to validate current levels, and suggest some potential targets. Support for the yuan from short rate differentials (1 and 2-years) peaked in late 2021, while that from longer yields (10-years) peaked in 2020. USD/CNH has been tracking well through this year with the 1 and 2-year CH-US differentials, but does show as undervalued to the spread between longer yields.

The relationship between USD/CNH and the 10-year interest rate differential suggests USD/CNH could comfortably reach levels around 7.50. In the near-term, market risk is that US rates are raised beyond current terminal pricing, and/or China eases monetary policy further. This indicates that upside pressure on USD/CNH can continue. As to the question of reaching 7.50, such a move would very likely require ongoing broad USD strength and a continued sluggish performance of the Chinese economy. Neither can or should be ruled out. A more important question to consider however, is whether Chinese authorities will allow the yuan to reach such weak levels?

Monetary officials are obviously concerned at the weakness in the yuan. But we stress that it is not yuan weakness in itself that is leading other currencies weaker, as it has done on previous occasions. Rather it is simply the fact of a strong USD impacting all major currency pairs. And further, that the pace of yuan weakness, or USD/CNH gains, is notably significantly less than a number of other prominent major currencies.

The primary threat or risk from further yuan weakness is that it may encourage or prompt capital outflow, more so than that already being seen, and in doing so make the task of stabilising and supporting the domestic economy more difficult.

China has already been keeping the daily USD/CNY fixes lower than would otherwise be expected based on movements in other major currencies against the USD. The result is that upside movement in USD/CNY is being restricted, as spot is limited to +/-2% from the fix each day. A imposition of a 20% RRR, from zero presently, for forward sales, has also been re-introduced, once again attempting to damp depreciation pressures by administrative measures. Direct market intervention is an option that has not yet been seen, though with other Asian central banks, including Japan and South Korea taking that action to support their own currencies, it may not be far away. Until that time however, ongoing USD strength will keep USD/CNH and USD/CNY bid. We highlight to take note of the daily fixing levels and the allowable trading band limits that result.

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