G10 FX: A tail of two halves

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USD – Shifting into neutral gear

No matter what index was used to gauge the performance of the USD this year, all of them would flag a banner year. Indeed, 2022 was one of the strongest years for the greenback in the post-Bretton Woods era. Attempting to generalize the story behind that strength is more complicated than you think, but its suffice to say though that it was the combination of endogenous and exogenous factors.

On the endogenous side, despite tighter financial conditions and generational levels of inflation, US consumption still held up as labor markets remained tight while wages increased. In addition, the Fed repeatedly underestimated the persistence of inflationary pressures. That led markets to recalibrate implied pricing for terminal on multiple occasions – which as many are aware, has been the key driver of USD strength this year.

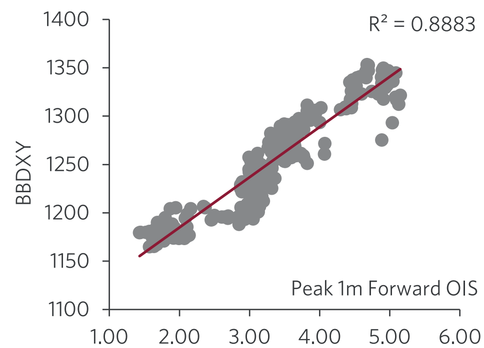
However, in the zero-sum world of currency markets, the USD has to be valued against *something*. And indeed, there were plenty of exogenous factors that also contributed to a stronger greenback this year. For instance, the decline in the EUR largely reflected the trade/energy shock of Russia's invasion of Ukraine and the corresponding sanctions. The devaluation in the GBP is a function of external imbalances becoming more expensive to fund amidst higher inflation, and fiscal issues. Finally, extant weakness in the JPY is a direct function of the Bank of Japan's yield-curve control policy amidst the move higher in global yields.

Looking ahead to 2023, we're shifting to a more neutral view on the USD.as we expect early year strength in the greenback to give way to weakness towards the second half of the year. Into Q1 2023, we envisage that the dollar should continue to perform as the Fed shifts to smaller-sized incremental hikes, and the market accommodates this shift by pricing in an elongated rate hike cycle. Additionally, the USD should still benefit from haven channels as the market digests the 'higher for longer' rates theme while risk and pro-cyclical assets underperform.

What eventually will turn the tide against the USD? The most likely candidate is an improved fundamental backdrop outside of the United States. As the winter subsides, we expect green shoots in the UK and Eurozone economies as local price pressures subside. Meanwhile, the Chinese economy should be well into its own re-opening phase by then as well, which will ease pressure on the domestic currency there.

In addition, we expect that the Fed's rate hike cycle will be complete, and short rates should stabilize. Greater certainty with where terminal rests means that the USD will lose a key source of support from Q2 and beyond.

Chart 1: The dollar has tracked market pricing for Fed terminal this year



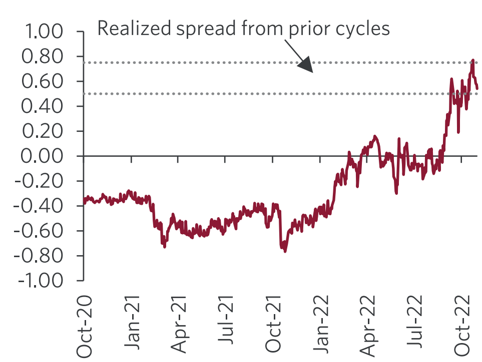
Source: CIBC Capital Markets.

CAD – Chin up CAD bulls, your time is coming!

Heading into this year, if we had told you that the Bank of Canada was going to hike the overnight rate by 350bps through November, and that oil prices would average near $100 per barrel, the logical conclusion would be that USD/CAD would likely be trading closer to par.

But reality in 2022 has been very different. The loonie has been mediocre on a trade-weighted basis for the most part, and it's bi-lateral performance against the USD has left a lot to be desired.

Chart 2: Fed/BoC implied spread over time



Source: CIBC Capital Markets.

The CAD's sub-par performance this year reflects a few important factors. First, the Fed's hiking cycle has been more aggressive than the Bank's. Of course, that a function of the strength of the US economy, but it's also due to the fact that policy transmission in Canada works quicker given the amount of debt that's carried on household balance sheets and the nature of the domestic mortgage/credit markets, which are shorter in duration than in the US. Second, the correlation between oil prices and the CAD have attenuated over time owing to a lack of investment in domestic oil sands for various reasons (including the rise of ESG mandates) while the US has also become a significant producer of energy.

Certainly, this has been a source of concern for the Bank of Canada. Amidst the most aggressive monetary policy tightening in decades, the rally in USD/CAD has meant that current financial conditions aren't as tight as they should be. Our in-house estimate of financial conditions shows that the FX sub-component is the only one that is contributing to easing in the index as opposed to tightening. BoC Governor Macklem has gone on the record by suggesting that policy settings might have to go further into restrictive territory for that reason.

Into 2023, the CAD's performance will be a factor worth watching to calibrate BoC policy. For now, we have the Bank reaching its terminal rate at the end of this year at 4.25% with some risk that could change to 4.50% early next year depending on incoming data. That will still be below Fed terminal and we expect that implied spread between both terminals should be in-keeping with prior cycles — which is between 50-75bps. This implies upside risk for USD/CAD into the new year and in Q1.

But beyond there? We expect we're closer to the end of CAD depreciation against the USD. While the domestic economy is expected to undergo a period of slower growth, we don't envisage a deeper downturn at this point. That's largely because labour market remains incredibly tight and job vacancies remain higher than normal at this stage of the economic cycle. This implies that the Canadian economy should be in a decent position to capitalize as the macro narrative turns in Q2, and ex-US fundamentals improve. Additionally, this should be the point at which the market has fully digested the implied spread differential between the Fed and the Bank of Canada as the former reaches it's terminal rate. That should cascade into profit-taking for long USD positions that have been built up for several quarters now.

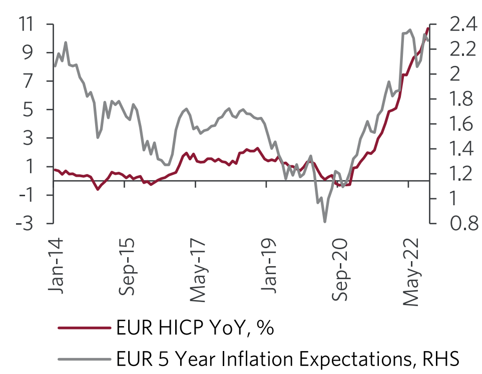
EUR – Looking through the immediate headwinds

The triumvirate of ECB doves, led by President Lagarde, Chief Economist Lane and Vice President De Guindos maintained a dovish narrative throughout last year. However, the last few months have been characterized by an energy-fuelled inflation spike resulting in a substantial shift in policy as the ECB has raised rates aggressively since the summer.

However, the hawks now appear on the verge of losing control of the policy narrative. The adjustment to the November statement language, as the ECB abandoned its commitment to hiking rates at the next several meetings allied to stating that the Governing Council had made "substantial progress in withdrawing monetary policy accommodation" point towards ECB tightening nearing the end zone.

Despite inflation likely maintaining an upward trajectory into early 2023, we anticipate the ECB will soon shift attention to the deteriorating growth backdrop. Updated ECB staff forecasts are likely to point towards headline CPI proving to be potentially three times the 2% target threshold in 2023. Even with these considerations, the ECB is moving towards an increasingly data-dependent approach. We expect sliding real economy data to compromise inflationary

Chart 3: Euro HICP and Inflation Expectations



Source: Eurostat, CIBC Capital Markets.

influences. Indeed, recent survey data points towards new orders retreating at the fastest pace outside periods of extreme macro stress. Beyond retreating new orders, we are also witnessing a graduated reduction in supply-chain pressures. While sliding real economy data will compromise inflationary pressures, the key inflation variable remains energy costs.

Europe's previous reliance upon Russian hydro-carbon exports has proved to be crudely exposed. Nevertheless, medium-run inflationary pressures "remain firmly anchored" according to Spanish central bank head Pablo Hernandez de Cos. Such assumptions are validated by the fact that despite headline CPI breaching 10%, long-term inflation expectations have not materially deviated from the ECB's 2% HICP target.

Of course, the stability in longer-term inflation expectations is likely helped by the rolling over in natural gas prices. The correction is a function of curtailed macro-activity in addition to administered efforts to reduce demand. While the price spike has been clearly inflationary, we also note the real economy impact, via negative trade adjustments. German industrial might, centered around automotive/engineering/chemical/and electric industries, has proved compromised via energy supply and price considerations.

Not only will a moderation in gas prices alleviate inflationary pressures, it will also promote a Eurozone current account rebound. A moderation in energy prices, allied to the ECB proving to be less aggressive than assumed by the market (thereby reducing potential demand destruction), provides scope for a more constructive EUR outlook. While near-term headwinds persist, we would anticipate that a competitive EUR, points towards a moderate EUR recovery narrative once market confidence regarding a 'peak dollar' gains further traction.

GBP – Another year of policy challenges

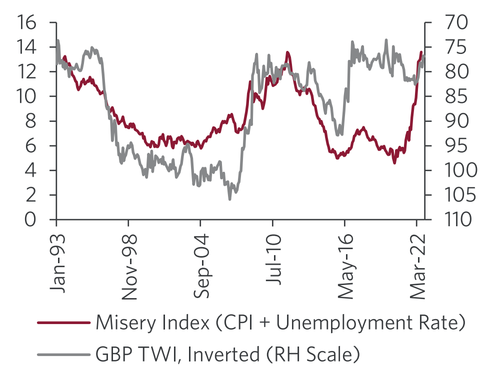
The last 12 months have been a rollercoaster for anyone investing in the UK. The country has had three Prime Ministers, the second of which attempted to push through the largest fiscal easing program since 1972. The immediate upshot of that 'mini budget' proved to be a near implosion at the long end of the Gilts curve, resulting in an emergency BoE rescue mission. Moreover, the country has faced rating downgrades with sovereign CDS nearing Covid-level extremes. While investor sentiment has been tested, inflation has registered forty-year highs, resulting in an almost unprecedented 290bps of BoE tightening.

Against such unparalleled uncertainty, the GBP has depreciated by around 12% versus the USD over the last twelve months. Albeit that correction masks the true scale of the downdraft, this comes as parity versus the USD was widely discussed as GBP/USD traded all-time 1.0350 lows on 26 September.

The UK's credibility discount is being gradually erased by new PM Rishi Sunak. Additionally, fiscal and monetary policy is once again complementary. However, the UK remains a broad macro underperformer, as the CPI profile remains elevated compared to its G7 peers. The combination underlines a solid rationale for near-term GBP challenges to persist.

The introduction of an Energy Price Guarantee has limited the CPI peak, the BoE assumed CPI peaking in excess of 13% prior to the EPG announcement. Nevertheless, CPI looks set to remain near double-digit levels into mid-2023. As a consequence, the BoE has been playing catch up as it has tightened for eight straight meetings, with the November 75bps hike taking the MPC into uncharted territory.

Chart 4: UK Misery Index and GBP TWI



Source: ONS, CIBC Capital Markets.

The UK consumer faces a protracted period of falling real earnings, weakening household balance sheets, and sliding discretionary spending. Falling consumer sentiment comes against a material upward revision in mortgage costs, almost 2m homeowners need to re-fix their mortgages by the end of 2023. The massive mortgage rate revaluation will compromise housing affordability metrics. Should nominal prices prove to retreat, we would be unsurprised should prices decline by up to 15%, substantive negative wealth effects will validate the challenging UK macro narrative.

While cost of living pressures drag on consumption, the government continues to attempt to regain fiscal credibility. The combination of a tighter fiscal and monetary policy outlook, undermining demand-driven inflationary influences, will limit the UK terminal rate. We assume that the BoE will struggle to take rates above 3.75%, well below that currently priced by the market. Moreover, against the backdrop of an ongoing and sizeable current account shortfall, policy credibility is a particularly important commodity for the UK. The shortfall underlines the continued resonance of former BoE Governor Carney's quote regarding the UK remaining reliant on the "kindness of strangers" to fund the imbalance. Portfolio flows are likely to remain a premium should UK fiscal, and political credibility be questioned.

While the current Conservative government attempts to eradicate the UK credibility discount, the ability to take necessary tough fiscal decisions risk being compromised by internal party dynamics. Ongoing political risk, and weak macro fundamentals underline that GBP bulls are set for another rocky year.

JPY – Preparing for normalization

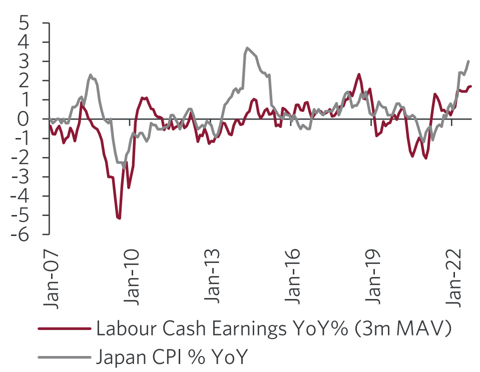
Over the last year, practically all the major global central banks, bar the BoJ, have front-loaded tightening. The BoJ remains an outlier despite headline CPI reaching 3.0% for the first time in three decades. The Bank, under soon-to-depart Governor Kuroda, continues to maintain an aggressively dovish stance via the perpetuation of Yield Curve Control (YCC), capping 10-year yields at 25bps.

Governor Kuroda appears intent on maintaining an easy policy stance until current cost-pull inflation turns into demand-pull price gains. Moreover, Kuroda remains determined that current monetary easing remains appropriate, at least until there are sustainable wage gains. However, annual labour cash earnings breached the 2% threshold for the first time since June 2018 in September. As earnings correlate with CPI, market pressure on the BoJ to abandon its easy policy stance is only set to grow.

The uptick in inflationary pressures, including core prices, suggests the conditions that warranted a cheap currency at the start of Kuroda's tenure, under 'Abenomics', are no longer relevant. Moreover, Governor Kuroda has recently talked of policy flexibility. Yet despite the market pressing for an adjustment in YCC strategy, the BoJ now owns almost 75% of outstanding JGB's in the 7-10-year maturity bucket, it seems likely that policy normalisation will be the job of Kuroda's successor once the incumbent steps down next April.

The disconnect between the BoJ and the Fed, as the market faces the higher-for-longer Fed, has resulted in an aggressive cheapening in the JPY. The perpetuation of the BoJ's ultra-easy stance, and a ceiling on 10-year JGB yields, resulted in 10-year UST-JGB spreads blowing out to levels not seen since 2001. Under such circumstances, the currency proved to be the safety valve, albeit the aggressive JPY cheapening resulted in the first MoF intervention since 1998. That being said, intervention did not deal with the cause of the Yen's problem — namely excessively easy monetary policy. That easy policy stance has resulted in leveraged and real money investors remaining materially JPY underweight since the end of Q1 2021.

Chart 5: Japan CPI and Labour Cash Earnings



Source: CIBC Capital Markets, Ministry of Internal Affairs – Japan.

As a net energy importer, Japan has been materially compromised by the aggressive global energy price shock. Indeed, Japan's previously virtuous trade and current account position has been compromised by energy price dynamics. Over the first two decades of the millennium, the country witnessed an average current account surplus of 3% of GDP. The surplus underlined that the JPY previously benefitted during episodes of financial market stress. However, the current account surplus effectively disappeared in H1 2022, erasing the perception of a safe haven premium. Should the recent energy price correction persist, boosting the Japanese terms of trade, expect this to encourage a boost in JPY fortunes.

The JPY remains excessively cheap under virtually any valuation metric. A correction in that undervaluation remains in the hands of the BoJ. In a post-Kuroda world, we can expect the BoJ to belatedly begin the normalization process, encouraging compression in UST-JGB spreads and recovery in JPY valuations.

AUD and NZD – Towards a major base, but not there yet

The year now nearly passed has been one where the high-beta credentials of both the Australian and New Zealand dollars have often been prominent. With some underestimation of US dollar strength, persistence of inflation, and of COVID restrictions, particularly in Asia, the path for AUD and NZD through 2022 often veered toward underperformance.

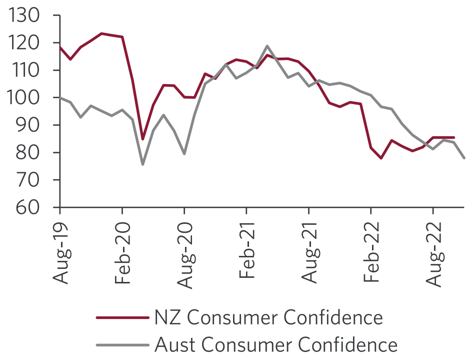
Looking ahead to 2023, both the global and domestic economic landscapes are expected to be somewhat uneven and challenging. For Australia and New Zealand, that will primarily be due to the influence of tighter domestic and global monetary policy. The persistence of inflation is seen easing and should see the pace of price rises moderate, especially under the influence of the policy tightening that has already delivered. Messaging from both the RBA and RBNZ have referenced the lagged impact of tightening. But still, the economic path for lower inflation to be achieved will predominantly need to be seen through slower growth and/or higher unemployment

One positive to be taken from 2022 is that the weakening of AUD and NZD currency values have already provided a pressure valve to slower trade and to softening confidence and activity. As a consequence, and while expecting the USD to remain firm through the first half of next year, downside moves in AUD/USD and NZD/USD are now approaching toward areas where we anticipate a base for both will be formed over coming months.

But with global and domestic tightening still to be delivered, the paths ahead for AUD/USD and NZD/USD are expected to be uneven, and will be so long as current and forecast interest rate differentials remain vulnerable to adjustment. Albeit that the levels of volatility in those measures will be less in 2023 as the market moves towards consensus terminal policy rates.

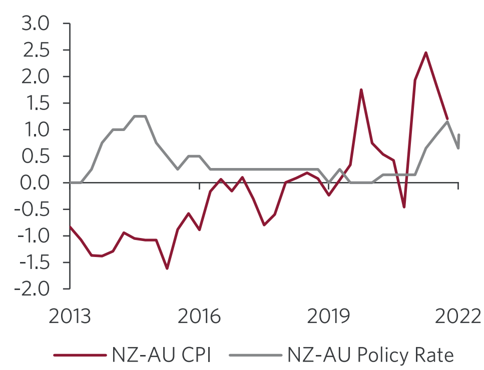
The RBNZ and RBA are both well-advanced in their tightening cycles, with the RBNZ having begun earlier and expected to reach a higher terminal rate than the RBA, in which case a later start and lower trajectory is playing out. Though we believe terminal pricing in both are presently excessive, due to differences in respective inflation levels and in household indebtedness (New Zealand at 122% of GDP vs Australia at 202% of GDP), the current spread between respective priced terminal and market yields will persist. In housing, both markets are correcting lower and both sectors are a near term drag on overall activity. From a current policy rate of 4.25%, we see the RBNZ raising the OCR to 5.00% and from the current 2.85% in Australia, we forecast the RBA to raise the cash rate to 3.50%. Peaks in both are seen to occur early in 2Q.

Chart 6: NZ & Australian Consumer Confidence near record lows



Source: Bloomberg & CIBC FICC Strategy.

Chart 7: Spread between NZ & Australian Policy Rates validated by CPI levels



Source: Bloomberg & CIBC FICC Strategy.

Through 2022, both AUD/USD and NZD/USD traded fairly in-line with the differential between respective 1y1y rates. At current levels we see both Australia and New Zealand 1y1y rates as over-estimating terminal policy rates, in both cases by between 50 and 75bps. With greater market clarity or confidence now present in expecting a terminal rate of near 5% for the US, we anticipate a narrowing or weakening of interest rate differential support for AUD/USD and NZD/USD to occur. Thus as above, we see both AUD/USD and NZD/USD testing support over the next two quarters, before a long-term base is formed. For AUD/USD we forecast potential lows around 0.6000 and for NZD/USD near 0.5500.

The interest rate spread between Australia and New Zealand has also been a strong lead to movements in AUD/NZD. With some divergence present between AUD/NZD levels and rate spreads still to resolve, and in expecting higher NZ yields to persist over respective Australian levels in 2023, we forecast modestly lower levels in AUD/NZD.

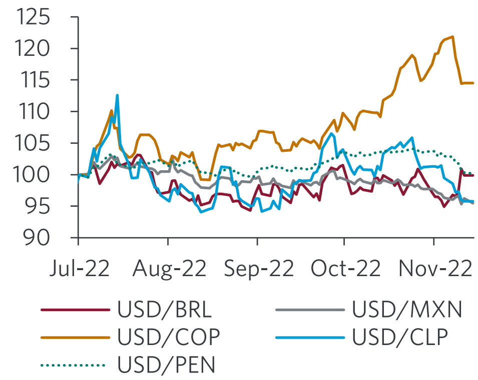
The AUD and NZD identification as high-beta currencies is intensified due to their exposure to both global and China activity, and particularly that one has not, as previously has been the case, offset the other. Australia exposure is perhaps more so than that of New Zealand due to the dominance of its trade in industrial commodities. While the global picture is dominated by the outrun to monetary policy tightening, China has been impacted by its adherence to its zero-COVID policy. There are early but unconfirmed reports that some restrictions will be eased. We believe the outright weakest levels of Chinese activity have been seen, though we remain cautious over inferring a swift recovery. But a stabilisation and recovery in Chinese activity and demand in 2023, which we do expect, again add to our expectation of both AUD/USD and NZD/USD forming lows in the first half of 2023.

Latam FX & Rates: Relative strength of the US and nearshoring trend will benefit MXN

Luis Hurtado

The strength of the MXN and BRL is a trend that has not gone unnoticed by investors in 2022. Among major currency pairs, the peso and the real appreciated 5.6% and 4.0% against the greenback since the start of the year, quite a stark contrast to the 12.2% and 9.4% depreciation of the GBP and the Euro, respectively, and the performance of regional currencies COP (-16.8%), and CLP (-8.1%) over the same period. Among the most common reasons supporting such a trend are Mexico's strong ties to US growth and Brazil's strong carry. The COP and CLP had faced larger idiosyncratic risks with changes in government in Colombia and concerns regarding structural reforms (pensions and taxes) and a new constitution process in Chile.

Chart 1: COP Underperformance Accentuates in H2 2022 (Index Jun 30, 2022:100)



Source: Bloomberg and CIBC Capital Markets.

Table 1: Large Twin Deficits Highlights Underperformance of COP

Economic Indicators	Colombia	Mexico	Brazil	Chile	Peru
Current Account* (% of GDP)	-5.10%	-0.80%	-1.40%	-6.50%	-3.00%
Nominal Fiscal Deficit** (% of GDP)	-5.50%	-3.20%	-6.30%	-1.50%	-2.40%
Gross Government General Debt (% of GDP)	61.10%	56.80%	88.20%	36.20%	34.80%
USD Debt (% of GDP)	21.80%	5.40%	3.80%	8.70%	16.60%
International Reserves (% of GDP)	16.50%	14.50%	18.80%	12.00%	32.00%

Source: Bloomberg, IIF, IMF, CIBC Capital Markets, Banrep, Banxico, BCB, BCCh, BCRP

*Bloomberg consensus forecast for 2022

** IIF – Global Debt Monitor

Table 2: Large Carry Favours BRL

Economic Indicators	Colombia	Mexico	Brazil	Chile	Peru
Current Inflation (y/y)	12.22%	8.70%	6.47%	12.80%	8.28%
Current O/N Rate	11.00%	9.25%	13.75%	11.25%	7.00%
12m Inflation Expectations (y/y)	7.27%	5.25%	5.12%	6.30%	4.89%
Ex-Ante Real Rate (Overnight rate – 12m inflation Expectations)	3.73%	4.00%	8.63%	4.95%	2.11%
Neutral Real Rate	1.4%-4.6%*	1.8%-3.4%	4.00%	0.75%-1.25%**	1.50%
Above or Below Upper Band of Neutral Real Rate Range (bps)	-87	60	463	370	61

Source: Bloomberg, CIBC Capital Markets, Banrep, Banxico, BCB, BCCh, BCRP

* In its latest Monetary Policy Report Banrep stated that the real rate may be higher than currently estimated (2%) – Previous studies put neutral real rates between 1.1%-4.6%

** 2019 Study by Banco Central de Chile.

With Mexico still benefiting from its proximity to the US and the acceleration of the nearshoring trend due to geopolitical concerns, we see MXN outperformance continuing into 2023. Nevertheless, net long positioning in the MXN, and the break below 19.4 in November makes as hesitant to recommend long positions against dollar. Hence, we prefer to reflect the MXN outperformance against the COP and/or CLP. That being said, and with expectations of US rates increasing and exerting downward pressures in the labour markets, equities and growth, we do not rule out swift and significant, albeit temporary, moves higher in USD/MXN and would like to capture those events via 3m USD/MXN call spreads.

Looking at the BRL, given the currency's attractive carry but lingering fiscal risks, we prefer selling USD/BRL spikes to the 5.30-5.40 range with a 5.05 target into early Q1 2023. In Chile, we see the CLP trading along with expectations about China's reopening policy. However, we see limited USD/CLP downside potential below 900 as reform concerns remain in place, and the country enters into recession. Finally, without signs of a more aggressive tightening cycle in Colombia or a potential FX intervention, we expect political risks and structural changes to the country's largest export sector to maintain downward pressure in the COP for the foreseeable future. Hence, we maintain our preference for buying USD/COP dips to the 4780-4800 range with a 5100 target into 2023.

MXN – MXN outperformance against Latam peers to continue in 2023

Among the reasons supporting the strength of the MXN in 2022, we have: 1) positive ex-ante real rates (also in restrictive territory); 2) positive trade surpluses; 3) the solid growth of remittances; and, 4) a stable flow of foreign direct investments. That being said, it is not itself surprising to see the MXN outperforming major and regional currencies. However, the heavy reliance on the US growth outlook underscores the risks ahead for the peso.

On that note, with US growth decelerating, we do not expect remittance and, by extension, local consumption to remain well supported in 2023 either. However, we expect the nearshoring trend to offset some of the upcoming headwinds for MXN, supporting our view of a steady but slow depreciation of the peso into next year and its continuous outperformance relative to regional currencies. Therefore, despite our expectation that the MXN will face headwinds in the short term, we continue to forecast that the MXN will be one of the outperformer currencies against the dollar in 2023. Note that Mexico's links to the US, lower cost of labour, and integration with supply chains in North America render the country one of the main beneficiaries of current global dynamics. Nevertheless, given lingering risks (i.e., geopolitical concerns, worsening of the global growth outlook and likely lower rate differentials between Mexico and the US), we prefer to reflect the view of swift and significant, albeit temporary, moves higher in USD/MXN via 3m USD/MXN call spreads.

BRL – Fiscal headlines will keep volatility high but lower USD/BRL bias to remain in place

Despite the BRL impressive rally at the start of November, USD/BRL is back to the 5.30-5.40 range as Lula's economic team gave a signal of a higher than expected spending cap waiver. The government expects the discussions to open the door for BRL130-198bln in new spending. However, the idea to permanently remove Auxilio Brazil welfare program from the spending cap caught the market by surprise.

Moreover, we highlight that Brazil has a known history of leaking the discussions of new fiscal spending as a way to test the market reaction before conversations reach a final stage. Hence, given the negative reaction across Brazilian assets to new and unexpected spending outside of the fiscal cap, we anticipate modifications to the final size and/or duration of the fiscal spending program, while we expect discussions on the need to enact a new fiscal rule to resurface in 2023.

Note that with the transition team discussing the waiver size and lingering fiscal risk into 2023, we expect high USD/BRL vols to remain in place. However, given some signals of economic pragmatism and stronger checks and balances in congress, we see sharp and quick BRL depreciating trends as an opportunity to reload long positions in the currency, in particular, against the COP. (See trades)

COP – COP to remain under pressure into 2023

During 2022 we highlighted that among the market's top concerns was Petro's position against new exploration of oil/coal. Unfortunately to investors, this fear materialized in the significant increase in the effective tax rate, the surge of the government's take in exploration projects within the recently proposed tax reform and the lack of new oil exploration contracts going forward. Both oil and coal accounted for over 50% of total exports and between 20%-30% of total FDI before the pandemic began. Moreover, lower oil reserves and declining production will likely exert downward pressures on USD receipts, leading to a sustained depreciation of the COP going in the medium term.

On the political front, the Liberal party, the U Party, and Conservative Party declared themselves part of the government coalition at the start of September, securing the government large majorities in congress and erasing initial expectations of solid opposition block in the legislative branch. From a market perspective, there is a strong believe that Minister of Finance Jose Antonio Ocampo is the only one holding the fort and sparing the COP from further depreciation. Nevertheless, given the constant outflow of populist comments in social media and perhaps conflicts at the executive level, local and external political analysts are already questioning his ability to remain in post for a prolonged period.

Although USD/COP posted new all-time highs, at the start of November, we remain very cautious about engaging in long COP positions. Note that structural issues (high fiscal and current account deficits) will continue to support a depreciation of the COP, while we expect headline risk to remain elevated with populist comments from President Petro and some members of his cabinet. We suggest buying USD/COP dips with a 5100 target into early Q1 2023.

Chile – Political moderation fails to provide enough support to the CLP

After testing 850 following the rejection of the new constitution and attractive carry, the CLP failed to find further support and resumed a steep upward in Q4. The depreciation of the CLP coincided with the BCCh's FX intervention program approaching its end, and major central banks increasing their hawkish rhetoric. Despite political moderation, we recognize that the current world dynamics (higher rate, lower growth, China lockdowns) are likely to keep the peso under pressure in the short term.

Moreover, Chilean lawmakers continue to discuss the details on another new constitution process. In the best case scenario, we expect to see the ratification vote on this new process to occur towards the end of 2023 or early 2024, maintaining political uncertainty elevated for another year. This situation not only puts a hold on investment decisions and takes a hold on consumer confidence, but it also delays the discussion of structural reform such as pension and taxes. In the worst case scenario, we could move into a gridlock in congress on how to choose the constitutional assembly members, leading to another plebiscite to decide the structure of the assembly, delaying the whole process to Q2 2024 and increasing social discontent. Hence, we prefer to adopt long MXNCLP positions given Mexico's reliance on exports to the US vs. Chile's dependence on China's growth.

China: Recovery will take time

Patrick Bennett

After USD/CNH ended 2021 near multi-year lows, our expectation heading into 2022 was of further appreciation of the Chinese currency. While the first few months of the year eked out some gains, the bulk of the year was dominated domestically by a very strong hand to contain COVID, the result of which was a hollowing out of domestic activity. Authorities responded with rounds of monetary and fiscal support, delivering that during a period, that is still ongoing, of significant monetary tightening in most other major economies. The major impacts were a slowing of domestic activity, an erosion of interest rate differential support and a related reversal of portfolio flow into China, and thereby a reversal of previous currency support. Gains in USD/CNH throughout the year were further driven by an overall strong US dollar.

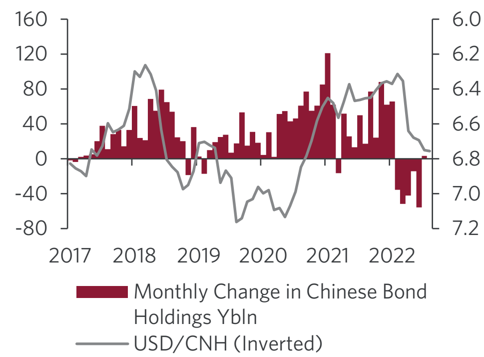
Heading into the end of this year, some emerging signs of a peaking in global, and in particular US hawkishness, are been seen. This in turn has prompted a consolidation in the USD broadly, and in USD/CNH to retrace modestly from all-time highs near 7.3800 recorded in late October. We expect trends in the USD to remain a major driver of USD/CNH in 2023, and in consideration of further USD gains to come before an eventual peak when around the time the Fed ends its tightening cycle, there is potential for USD/CNH to again track higher in the first months of the coming year.

On a longer-term outlook, a recovery in the CNH will only gain traction once the Chinese domestic economy is on a recovery path. Recent data points on domestic demand and new lending have been disappointing, and to large degree reflect the impact of zero-COVID policies. Announcement of steps to ease the impact of COVID restrictions recently announced were both welcome and noteworthy. Though we point to the depth of economic weakness already showing as indicating there is a huge amount of work to be done to regain even modest economic momentum.

Running alongside zero-COVID policies, has been an ongoing and concerning slump in the property sector. Travails in the sector are not entirely new, and have also attracted a number of policy support measures. But the work-out is expected to take some extended time, and given the significance of the sector to the economy, comprising up to 30% of GDP, the drag to overall activity will continue, in turn presenting headwinds to eventual currency recovery.

During 2022 USD/CNH traded more as a function of broad USD movements than in recent years. We expect that will continue in 2023, even as monetary authorities will remain active to damp excessive volatility, and in turn discourage capital outflow. The other key driver for USD/CNH will be the state of domestic and global economic momentum, with both landscapes expected somewhat uneven and challenging. While we identify there are significant challenges for the Chinese economy to regain a positive trend, it is notable that while this can occur in 2023, it will be at the same time as other major global economies are slowing under the influence of monetary policy tightening delivered and still to come. A recovery is domestic activity many thus occur at the same time as the external sector is weak. A recovery in the CNH will take time and we peg the currency as no more than a market performer amongst major currencies against the USD in 2023.

Chart 1: Portfolio withdrawal from China reflected in CNH weakness



Source: Bloomberg & CIBC FICC Strategy.

Table 1: CIBC FX Forecasts

	Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2024 Q2	2024 Q4
USD/CAD	1.38	1.36	1.34	1.34	1.32	1.32	1.28
EUR/USD	0.99	1.00	1.02	1.04	1.07	1.10	1.10
USD/JPY	140	138	136	135	130	127	124
USD/CHF	0.97	0.98	0.98	0.98	0.97	0.95	0.96
GBP/USD	1.13	1.14	1.15	1.16	1.18	1.22	1.23
AUD/USD	0.63	0.64	0.64	0.65	0.66	0.67	0.69
NZD/USD	0.58	0.60	0.61	0.62	0.62	0.63	0.65
USD/CNY	7.10	7.10	7.00	7.00	6.90	6.85	6.80
USD/MXN	20.00	20.50	21.50	20.50	19.80	20.50	21.00
USD/BRL	5.20	5.20	5.05	5.20	5.40	5.20	5.00
USD/CLP	920	950	920	920	960	920	880
USD/COP	4800	5000	5100	4800	4800	4700	4700

About CIBC Capital Markets

CIBC Capital Markets works with domestic and international organizations looking for a banking relationship that combines in-depth industry knowledge with comprehensive capital markets, corporate banking and investment banking capabilities to address their most pressing needs. We strive to forge strong and deep relationships with our clients to understand the demands of their business and bring distinctive and appropriate solutions to the table.

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