Monex August 2022 **FX Forecasts**

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Introduction

The past month will predominantly be remembered for developments in Europe as restricted gas supplies from Russia threatened to tip major euro-area economies into immediate recession and intensify already-high inflation pressures. At the same time, battling an acute cost of living crisis, the Italian coalition government under former ECB President Mario Draghi collapsed and brought political risk back into the fold. In currency markets, these developments meant the limelight was firmly on EURUSD, with the pair making repeated attempts at breaking parity before finally breaching the threshold for the first time since 2002 on July 14th. Although at this point the end game for Nord Stream 1 deliveries was unknown, price action in EURUSD reflected the increased probability of the worst-case scenario for Russian gas flows and the corresponding growth impact. However, shortly after, news from Gazprom suggested that gas flows via the Nord Stream 1 pipeline would come back online in a limited capacity once planned maintenance was completed.

This saw the **single currency rally back towards the 1.02 handle**, a move that was compounded by Reuters sources suggesting **the ECB was actively discussing a 50bp hike later that week**.

The increased risk of a pronounced stagflationary shock from energy market developments resulted in the European Central Bank delivering on the Reuters sources story and unexpectedly hiking rates by 50 basis points. This effectively marked the end of negative interest rates in the euro-area as the Governing Council sought to front-load its hiking cycle to prevent any further de-anchoring of inflation expectations. Given much of the market reaction was already baked in due to the leak earlier on in the week, the euro didn't rally much further on the rate announcement. Instead, we viewed the ECB's decision at the time as providing more support for the euro above parity; this proved correct as EURUSD fluctuated around the 1.02 handle for the remainder of the month before closing out July at 1.0227.

The rationale for a larger-than-expected rate hike was also shared by the Bank of Canada, which shocked markets with a decision to raise interest rates by 100 basis points the week before the ECB announcement. By doing so, the BoC regained its position in front of the Fed during this tightening cycle following the Fed's pivot to 75bps in June. Yet despite the focus of central banks resting firmly on tackling rising inflation, markets soon began to factor the repercussions of a further tightening in financial conditions into growth outlooks. This saw most G10 yield curves flatten further in the middle parts of the month, with the US Treasury curve even inverting over the 2Y-10Y horizon by the most since the 2000 dot-com crash. Monetary easing over the medium term was also factored into swap curves, with rate cuts priced as early as Q2 2023.

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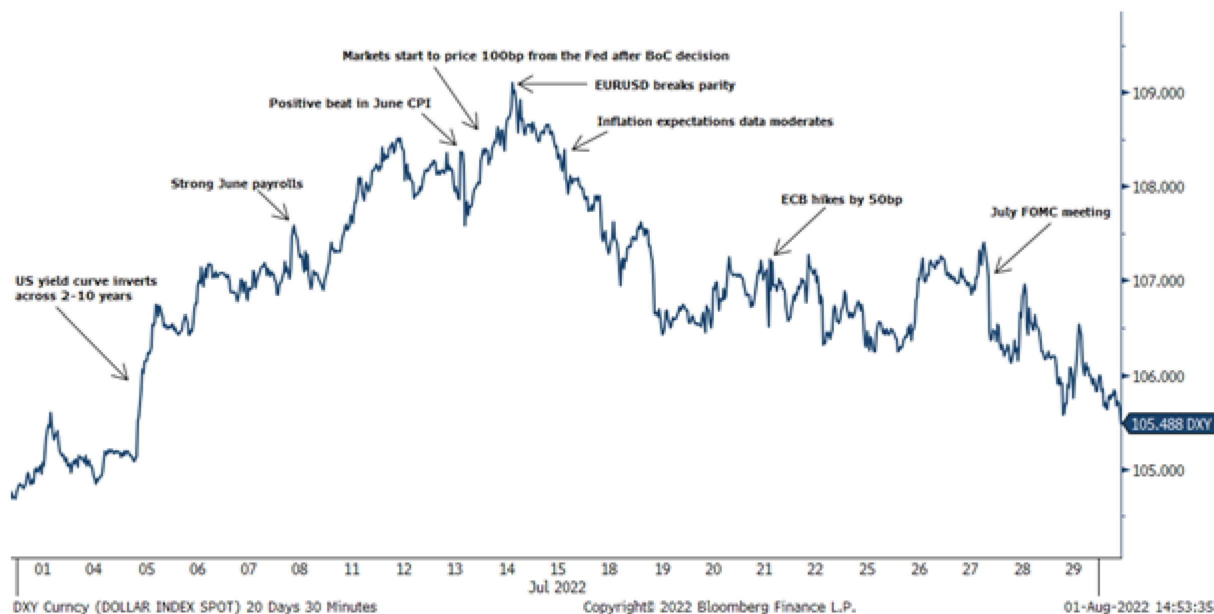
August 2022

Chronology of DXY price action over the course of July



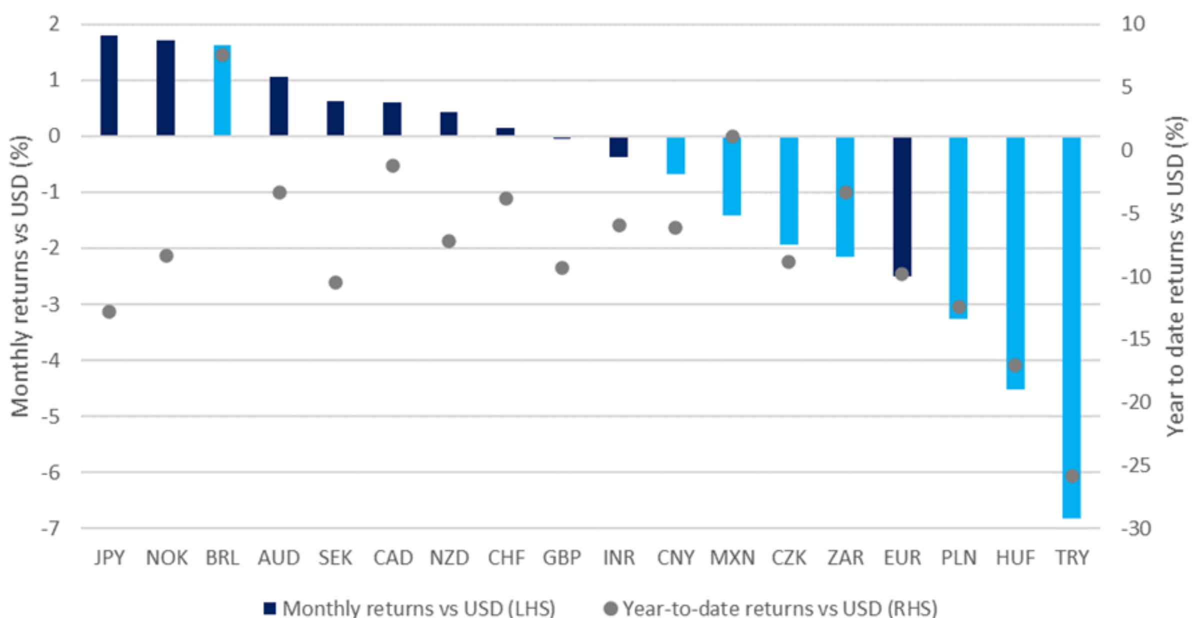
For the dollar, the combination of tighter monetary policy and increased recession risk was initially positive, leading to a fresh multi-decade high in the broad dollar DXY index. However, the greenback's party ended abruptly on July 15th following the arrival of July's preliminary inflation expectations data from the University of Michigan. After the very same indicator prompted an eleventh-hour shift from the Fed to 75bp increments back in June, the moderation in longer-term inflation expectations this time saw markets begin to price out the prospect of a 100bp hike in July, which in itself was only weighed as an option following the BoC decision. The repricing of July's meeting was further compounded when FOMC members Waller and Bullard, two of the more hawkish committee members, suggested that markets had gotten ahead of themselves when pricing the possibility of a full percentage point move. Guidance by both Waller and Bullard proved correct as the Fed followed through on its previous communications at their July 27th meeting, hiking rates by 75bps while delivering a rate statement that was little changed from the month prior. Instead, it was the press conference held by Chair Powell that moved the needle for the dollar. After tailing off from a multi-decade high the week prior, the dollar found itself under renewed pressure as Chair Powell endorsed the June dot plot while also highlighting the Fed's increased sensitivity to growth conditions now policy rates have expeditiously returned to neutral territory. After Powell opened the US rate path to growth data, the arrival of another negative surprise in US GDP data just the day after the Fed meeting resulted in a further dovish repricing in the US rates space and downward pressure on the dollar.

Overall, developments in July have endorsed our medium-term view on the dollar, which foresees a more sustained depreciation towards the end of Q3 due to the deceleration of the Fed's hiking cycle as policy enters restrictive territory and the economy begins to feel the full effects of tighter financing conditions.

With demand destruction already entrenching itself in some sectors of the US economy such as manufacturing and housing, we expect a weaker growth outlook to limit the ability of firms to pass on higher costs to the consumer.

Ultimately, this should start to weigh on core inflation pressures, while headline inflation naturally moderates due to the recent fall in global commodity benchmarks and negative base effects. In our view, this should reaffirm Chair Powell's recent stance that policy tightening will enter a slower phase from September. Ahead of then, the DXY index is likely to remain supported at elevated levels, owing to the weighing of the euro in the DXY basket and our expectation that the euro-area's growth outlook will force another run on parity this month. Additionally, concerns around the global growth outlook are likely to limit the extent to which risk assets can rally without a co-ordinated shift in monetary policies. Risks to this view are to the upside and largely centre on elevated wage pressures and the level of persistence in core inflation pressures. Both of which will keep the Fed locked into an aggressive hiking cycle heading into an economic slowdown.

G10 currencies with weak year-to-date performance predominantly led gains vs USD in July as pressure from US yields subsided



Our thoughts on EUR, GBP, CAD, CHF, Scandies and CE-3

EUR

Although the single currency broke through the parity threshold in July, its failure to consolidate at these historic lows was notable. This was largely due to institutional dip buying, support from the ECB's hiking cycle, and a reduction in left tail risk to the euro-area growth outlook as gas supplies started to come back online. While we expect cheap historical valuations and the ECB's hiking cycle to continue providing support to the single currency, this will unlikely deter a more sustained test of parity as markets discount the euro on growth concerns in the region as the economy tips into recession in H2 due to energy market developments– signs of which are already apparent in German data. Over the coming quarter, our expectation of looser global financial conditions following a pivot from the Fed and renewed focus for monetary policy on growth conditions should help stabilise global risk assets, providing support for a beleaguered EURUSD. While this helps to maintain our bullish medium-term outlook on the euro, we have downgraded our projected path to account for the lower growth outlook in the eurozone. Risks to our near-term forecast are skewed to the downside, with the potential for EURUSD to trade in a range of 0.95-1.00 highly likely under a scenario where a sudden stop in gas supplies results in policy-induced demand destruction via rationing, a downwards adjustment in potential euro-area growth and a lower ECB terminal rate as a result.

GBP

The downturn in the euro-area growth outlook at the beginning of July not only saw EURUSD test parity but also pushed cable to fresh multi-year lows.

Under our expectation of a euro-area recession in H2 and more dovish rate path for the BoE Bank Rate relative to money market pricing, we expect GBPUSD to come under renewed pressure this month.

Risks to our near-term forecasts are balanced. To the downside, a more sudden stop in Russian gas flows will likely see GBPUSD get dragged back below the 1.20 threshold due to reluctance by traders to price a substantially stronger GBPEUR rate, while a more supportive risk backdrop driven by a further dovish repricing in US rates poses upside risks. While a 50bp hike by the BoE in August should pose upside risks to our forecasts given our base case for a 25bp hike, we think the bar for the BoE to endorse current market pricing is too high for the Bank's forward guidance to clear. Ultimately, this should result in the Bank's latest decision being viewed as underwhelming for markets irrespective of the size of the interest rate hike. Against the euro, the pound's path is more

navigable. On a monetary policy basis, we think the BoE's hiking cycle is more secure in H2 than the ECB's, owing to a more pronounced slowdown in euro-area growth conditions and a delayed peak in headline inflation in the U.K.. Additionally, under the scenario of a more pronounced European energy crisis, the UK's economic outlook is unlikely to be as impacted as the eurozone's, suggesting growth differentials will favour further upside in GBPEUR towards recent highs of 1.21. We have therefore adjusted our GBPEUR forecasts higher.

CAD

The combination of the Bank of Canada's hawkish decision to hike rates by 100bps in July and the expansion of the Fed's reaction function to incorporate growth conditions has led us to revise down our near-term USDCAD forecasts. However, despite our slightly more bullish CAD view, we continue to expect the Canadian dollar to underperform the broader rally in G10 currencies towards the end of Q3/ start of Q4, owing to the currency's correlation with broader USD developments due to the level of integration between the US and Canadian economies. Compared to the broader rally in pro-cyclical currencies, which we believe will be sparked by a deceleration in the Fed's tightening cycle, the Canadian dollar will likely have to await an improvement in broader global growth prospects before rallying towards the 1.20 handle. Although growth conditions are likely to slow heading into the winter months, we believe a dovish readjustment in global interest rates will shelter a further deterioration in growth conditions, allowing the loonie to trade on a firmer footing at the start of 2023.

CHF

Following the Swiss National Bank's June 16th meeting, where rates were pre-emptively raised by 50bp and Governor Jordan introduced two-way intervention risk into CHF crosses to stem imported inflation pressures, the Swiss franc has rallied over 6% against the euro and nearly 4.5% against the dollar. Once adjusted for inflation and measured in trade-weighted terms, the metric in which we believe the SNB is monitoring for the inflation passthrough, the Swiss franc has appreciated nearly 6%. With the CHF real effective exchange rate now sitting at levels last seen in early March where intervention risk to depreciate the franc were elevated, we think the SNB's tolerance for a stronger CHF will start to diminish. Owing to the downturn in euro-area growth conditions and the likely widening in peripheral bond spreads due to increased Italian political risk, we expect the franc to continue appreciating against the euro over the coming month, but for gains to be marginal and partially offset by depreciation vs the dollar.

In our view, this should reduce the need for the SNB to verbally intervene in markets as the CHF REER rate remains at tolerable levels.

Scandies

Downgrades in the euro-area growth outlook tends to have negative impacts on NOK and SEK, however, both currencies have recorded gains in excess of 3% against the euro since the start of July. While in Norway, this is largely a terms of trade story due to the rise in European energy prices, which we think should continue to drive EURNOK lower heading into the winter months when energy demand rises, the rally in the Swedish krona has been due to increasingly hawkish expectations of the Riksbank following the jump in headline inflation in June. Money markets are now pricing a rate hike of over 100bps by the Riksbank at September's meeting, which factors in expectations that the Swedish central bank will need to hike rates at an emergency unscheduled meeting prior to then. This should support further SEK appreciation against the euro over the coming months, but given the regions growth outlook, we expect NOK to continue outperforming its Scandinavian peer over the forecast horizon.

CE3

CE3 currencies have been under immense pressure since the outbreak of war in Ukraine, largely due to geographical proximity to the war, reliance on Russian energy exports, and association with eurozone growth conditions. Although geographical risk is now playing less of a prominent role in CE3 price action, currencies within the region broadly remain under pressure. This is due to the region's direct exposure to Russian energy supplies, particularly in the case of Hungary, and the downturn in eurozone growth indicators. Under our base case for euro-area growth in H2, we expect CE3 currencies to remain under pressure against both euro and USD. However, the dispersion of depreciation is unlikely to be equal. We expect the Czech Nation Bank to continue leveraging its ample FX returns to keep the EURCZK rate stable through the next few months, while HUF to underperform regional peers due to the limited impact rate hikes are having on the currency's performance and the Hungarian economy's high exposure to growth headwinds.

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Forecasts

Currency Pair	1-month 31st August 2022)	3-month (31st Oct 2022)	6-month (31st January 2023)	12-month (31st July 2023)
		G10		
EUR/USD	1.00	1.02	1.04	1.10
USD/JPY	130	125	120	115
GBP/USD	1.20	1.24	1.26	1.30
USD/CHF	0.965	0.950	0.940	0.910
USD/CAD	1.28	1.28	1.26	1.22
AUD/USD	0.70	0.71	0.73	0.75
NZD/USD	0.64	0.64	0.67	0.69
USD/SEK	10.2	10	9.7	9.3
USD/NOK	9.60	9.41	9.13	8.55
DXY	107.11	104.78	102.54	97.74
		Emerging Markets		
USD/CNY	6.79	6.8	7	7
USD/INR	79	77	75	75
USD/ZAR	16.5	16	15.5	15
USD/TRY	18	18.5	18.5	17.5
USD/PLN	4.80	4.71	4.52	4.00
USD/HUF	410	412	394	355
USD/CZK	24.5	24.3	23.6	21.8
USD/BRL	5.5	4.8	4.8	5
USD/MXN	20.5	19.8	19.5	19
		Euro Crosses		
EUR/GBP	0.83	0.82	0.83	0.85
GBP/EUR	1.20	1.21	1.21	1.18
EUR/CHF	0.965	0.97	0.98	1
EUR/CAD	1.28	1.31	1.31	1.34
EUR/SEK	10.2	10.2	10.1	10.2
EUR/NOK	9.6	9.6	9.5	9.4
EUR/TRY	18	18.87	19.24	19.25
EUR/PLN	4.8	4.8	4.7	4.4
EUR/HUF	410	420	410	390
EUR/CZK	24.5	24.8	24.5	24.0
EUR/BRL	5.5	4.9	5.0	5.5
EUR/MXN	20.5	20.2	20.3	20.9

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