Monex September 2022 **FX Forecasts**

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Introduction

The usual summer lull in markets was absent again this year as global recession concerns and the threat of persistently above-target inflation kept both traders and central bankers on their toes. While this ultimately fed into the dollar DXY index, which reached a new multi-decade high, the upward trend in the broad dollar was isolated to the second half of the month. During the first two weeks of August, the dollar mostly traded sideways, albeit with increased volatility as markets continued to digest each piece of economic data to determine the Fed's next step in September. The difficulty in this was that the data provided conflicting messages. It wasn't until global recession fears started to re-emerge that the playbook readily used for most of this year came out once again: seek dollar liquidity as a haven play.

Dialling back the clock to the opening days of the week, the **broad dollar traded on a mixed footing as global macro conditions** didn't show the most **definitive trend.**

On August 1st, July's US ISM data reinforced the positive risk environment that was in place since the July Fed meeting as it showed abating price pressures and employment intentions, while output steadily plodded along. But in the following days, despite US data continuing to send constructive messages to markets as factory orders and services indicators printed above expectations, a surge in geopolitical risk as Nancy Pelosi landed in Taiwan sparked the first leg of substantial dollar strength. The dollar bid in the risk-off environment was compounded by hawkish Fed commentary; led by San Francisco Fed President Mary Daly, Fed members soon started to push back on the loosening in financial conditions since the central bank's last meeting in late July. The dollar's strength was short-lived, reversing on Thursday the 4th as China began to de-escalate the military exercises that it conducted in the Taiwan strait in response to Pelosi's visit, while a string of positive earnings reports boosted equities and overall risk appetite. The improvement in risk conditions was telling because even the pound managed to notch a slight gain against the dollar that day, despite the Bank of England caveating its first 50bp hike of the cycle with a stark recession forecast. Positioning ahead of July's nonfarm payrolls was also likely at play as a consensus emerged that employment growth would slow on easing labour demand, effectively putting less pressure on wage growth. Those predictions missed the mark, however, as payrolls came in almost twice as strong as the highest estimate.

This sent the dollar higher as markets began once again to price a third 75bp hike from the US central bank in September.

It wasn't until the following Wednesday when July's CPI report was released that the dollar faded its payroll rally as hawkish expectations were trimmed yet again. The drop in

the DXY index to a low of 104.64 in response to the inflation data marked the bottom for the dollar in August. Afterward, the dollar charged ahead at full speed, even though money market pricing for the September meeting never returned to the highs it recorded following the release of the payrolls data. The main reason was that the market's focus quickly shifted from Fed pricing to recession concerns in Europe and China.

The DXY index bottomed out after the release of July's inflation data as growth concerns in Europe and China dominated thereon

The first trigger of this inflection in the broad dollar came overnight on Monday the 15th when the People's Bank of China cut its 1-year medium-term lending facility by 10 basis points to 2.75%. The rare decision to ease the main policy rate was a precursor of what was to come: just 30 minutes later, a batch of economic indicators showed that the Chinese economy slowed across all sectors in July. At the same time, continued supply disruptions in natural gas markets coincided with increased European demand as nations tried frantically to increase inventories, prompting the start of an exponential rally in European energy futures. The one-two punch that these events delivered to the global growth outlook's chin in just a matter of days initiated a broad-based haven bid for the dollar. The greenback's strength continued as gas prices rose even further in Europe, while water levels in key coal transportation rivers fell, prompting energy benchmarks to skyrocket throughout the continent. Traders made quick work in dumping the euro in this environment, pushing the currency below parity with the dollar. Although parity had been briefly breached earlier this summer, this time the move consolidated overnight for the first time since 2002. After that point, the dollar lost steam and began to stabilise at

historically high valuations, while volatility remained high due to the fluidity of the macro environment. The initial reason for the dollar's plateau was that Europe's flash PMIs for August held up better than expected, especially when compared to the US reading. Further USD headwinds came in the form of negative surprises in US PCE and personal consumption data on Friday afternoon, although these were quickly offset by a hawkish speech from Chair Powell at Friday's Jackson Hole Symposium.

As financial conditions loosened back in July after Chair Powell suggested the hiking cycle would soon begin to slow, the still-fresh memory led the Fed Chair to deliver an unambiguously hawkish message at Jackson Hole.

Powell stressed that the more gradual approach to rate hikes going forward merely reflected caution as opposed to a bias toward easing. To reinforce his anti-inflation message, he said that interest rates would remain in restrictive territory for longer than the markets had priced, with no cuts to be expected in 2023. The speech was a success in this regard as markets soon priced a slightly higher terminal rate from the Fed and also trimmed expectations of policy easing in the second half of 2023. As Asian markets adjusted to Powell's commentary in the early hours on Monday 29th, the DXY index spiked higher to touch a fresh multi-decade high. But, as has been the case since the release of the global flash PMI data, the dollar quickly faded this overnight rally as European traders entered for the week. At this point, European gas inventories were practically at the 70% threshold outlined by the European Commission as the minimum level required ahead of the winter months. This took some of the emphasis away from European gas markets when pricing the euro and a relief rally quickly ensued.

Reinforcing the EURUSD retracement above parity was hawkish commentary by ECB members, which led markets to price end-of-year interest rates around 35bps higher.

While the dollar's price action over the course of August was choppy on a daily basis given the fluid nature of the macroeconomic environment, taking a bird's eye view and looking at the month as a whole lends a clearer perspective. The dollar's gains were largest against currencies with high exposure to global growth conditions (SEK, ZAR, NOK, NZD), those undergoing substantial terms-of-trade shocks (GBP and EUR), and those with high sensitivities to rising back-end Treasury yields (JPY). Meanwhile, owing to its close integration with the US economy and similar pace of rate hikes, the Mexican peso remained resistant to the downturn in overall risk conditions over the course of the month.

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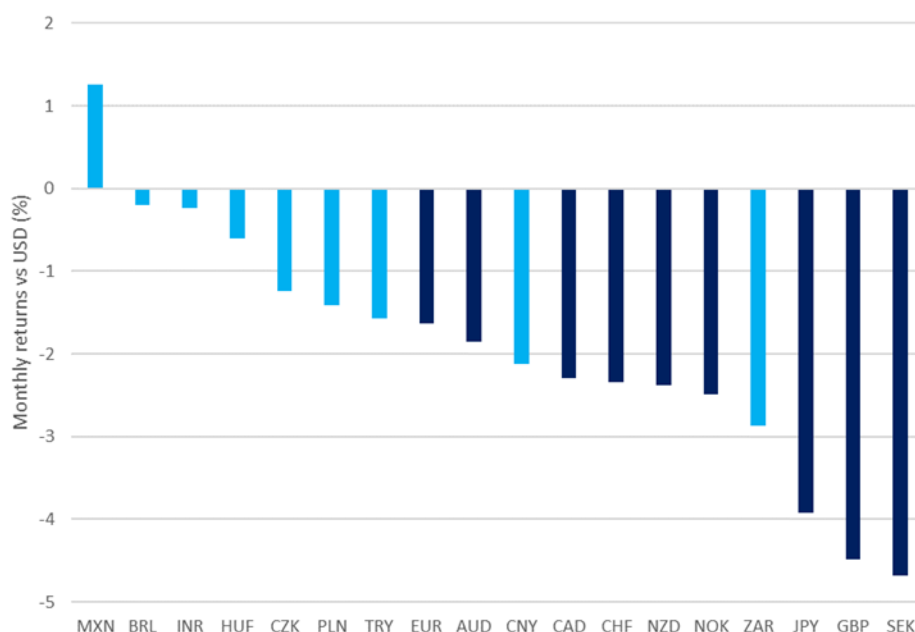
Losses in G10 currencies are substantial in August as stagflation risks really started to bite



Looking ahead, Powell's statement of intent in his Jackson Hole speech has resulted in us upgrading our near-term forecasts to be more bullish on the dollar as we no longer expect the Fed's downshift to 50bps in September to be as supportive for overall risk conditions. In equities specifically, which have been a dominant driver of cross-asset risk appetite, we think the combination of a slowdown in US and global growth with a prolonged period of tighter US financial conditions renders the outlook fairly bearish in the coming quarter. We now look for the strong "no alternative to the US dollar" narrative to crack in early 2023, at which point inflation conditions should have moderated substantially, while growth conditions are likely to rebound. Only then, once both channels fuelling the dollar's strength have closed—the haven property and US rates differentials—do we expect a structural decline in the greenback.

We should note that the risks to our near-term forecasts that stem from the macro backdrop's fluidity are unusually high. The main risk is policy uncertainty: changes to the labour market, savings habits, and supply chain dynamics following the pandemic have not fully reversed, while the war in Ukraine and subsequent energy and food security crises have led to the unusual state of stagflation. Accordingly, policymakers have no historical playbook to draw upon when calibrating fiscal and monetary policy. In addition to the risk of policy errors, the pace of disinflation is also highly uncertain. On the one hand, greater persistence in core price pressures would likely drive terminal rate expectations higher, further restricting growth and probably extending the dollar's haven bid. On the other hand, a faster decline in headline inflation should support risk conditions as terminal rate pricing is reduced. This will favour currencies with cheap valuations, i.e. JPY. While risks to our forecasts remain elevated at present, the sheer amount of information provided in September due to the number of central bank events and top tier economic releases should provide a clearer path going into Q4.

Our thoughts on GBP, EUR, JPY, CNY, CAD, LatAm and CE-3

GBP

Under our previous base case, we expected that GBPUSD would come under renewed pressure as the Bank of England pushed back on the market pricing of their rate path and recession concerns in the euro area took their toll. While these expectations ultimately came to fruition and saw GBPUSD trade down to our one-month forecast of 1.20 in the middle of August, downside risks began to materialise. Firstly, despite the UK's limited exposure to Russian energy, the impact further supply constraints on European wholesale energy markets amplified the stagflationary shock to the UK's economic outlook. This saw inflation expectations continue to rise, even after Ofgem announced an 80% increase to the consumer energy price cap in October, with some economists suggesting headline inflation could peak at a rate above 20% in January. With the Bank of England already signalling a prolonged recession under the previous implied rate path, the impact that rising inflation expectations had on money markets and Gilt yields provided little support for the ailing pound. With the ability of the Bank of England's interest rate channel's to support the pound neutralised by the impact it would have on the magnitude of the recession, the focus shifted quickly to fiscal support. But, with the Tory leadership race not set to conclude until September 5th, the political vacuum only fanned the tantrum in UK assets toward the end of the month.

Given the substantial deterioration in both the UK's economic outlook and its balance of payments over the course of August, we are downgrading our GBP forecasts against USD and EUR both to mark-to-market and to reflect our increasingly bearish view on the pound.

Under our base case assumption, Liz Truss will be appointed as the Prime Minister, and she should provide a sizeable level of fiscal support for businesses and households through the winter months. Nevertheless, this does little to offset the bearish sentiment being factored into GBP at present given the increasing left tail risk to the UK economy and the need for the Bank of England to tighten policy further in order to mitigate against the second round effects of the latest inflation shock. Until year-end, we view the risks to our GBP forecasts as tilted to the downside.

EUR

Despite breaking through and consistently trading below parity against the dollar in August, price action in the single currency highlighted a willingness by institutional investors and corporations to pick up the historically cheap euro. This ultimately saw the

EURUSD pair finish the month close to our one-month forecast at 1.005. The balance struck between market players around the parity level is telling and suggests this will remain the equilibrium level for the pair until Europe's energy outlook over the winter months becomes clear. As things stand, further maintenance is underway on the Nord Stream 1 pipeline and European gas inventories sit above the 70% minimum threshold required by the European Commission. While the latter has partially offset the impact of restricted flows on EURUSD, these inventories won't prevent energy rationing over the winter months should consumption unexpectedly need to rise and gas flows remain offline. To reflect this near-term uncertainty, we are holding a neutral view on the single currency over the coming quarter, but stress that these forecasts will remain under constant review as new information comes to light around Europe's energy inflows and outflows. In 2023, the path for the euro is easier gauged as global risk conditions should have improved under lower inflationary pressures and the eurozone economy should be in recovery following a winter recession, aided by government-led investment in energy diversification.

Nonetheless, we think the longer-term fair value for **the euro has fallen due to the reduction to potential supply in the eurozone.** Reflecting this, we are maintaining our conservative 12-month forecast at 1.10.

JPY

Despite global growth concerns and a renewed downturn in global equities, the Japanese yen weakened toward a historical low in August as pressure from US rates resumed following the Jackson Hole Symposium. At 3.2%, however, we believe the US 10-year has likely reached a near-term top, barring any hawkish readjustment in the Fed's longer-run interest rate range in September's dot plot. With growth indicators set to deteriorate further in the coming months, we believe the muted pressure from US rates and the yen's haven attributes should prove conducive to a marginal retracement in the USDJPY rate. Risks to these forecasts centre largely on upcoming US CPI reports and the extent to which disinflation eases the pressure on the Fed to take policy further into restrictive territory.

CNY

Our expectation of narrowing rate differentials and a slowing in the Chinese economy driven in large part by China's Zero-Covid policy has led us to be bearish on the Chinese yuan since February. This has only been emboldened by the PBoC's decision to ease the 1-year medium-term lending facility rate in August amid a housing-led slowdown in the economy and signs of further Covid restrictions being implemented as case counts continue to rise. However, the recent actions by the PBoC to push back against CNY depreciation suggest that downwards pressure is likely to ease unless widespread lockdowns are implemented ahead of the National Congress in October. We have therefore flattened our near-term USDCNY profile as the currency edges closer to the politically sensitive 7.00 handle. Policymakers' desire to slow the rate of CNY depreciation will likely be supported by additional fiscal stimulus measures, which we think could be

announced later this year to prop up domestic growth. That should also offer a modicum of support to other currencies in the APAC region with high exposure to Chinese growth conditions.

CAD

We are maintaining our fundamental view on the interest rate path for the Bank of Canada, as well as the differential between Canadian and US interest rates. That is, the Bank of Canada will likely try to pre-empt the Fed's decisions in order to show initiative and independence to markets. Furthermore, a front-loading in the hiking cycle will help to anchor inflation expectations. In this view, both central banks should start to slow the pace of monetary tightening from September onward, with terminal rates of 3.5 to 4% being reached by the end of the year. Nevertheless, following Jerome Powell's forceful speech at Jackson Hole and Neel Kashkari's comment that he was "happy" to see risk assets fall in response, we have updated our view on what our expected rate path implies for the Canadian dollar. Previously, our expectation was that the deceleration in the Fed's tightening cycle would be supportive for risk assets and the loonie as it signalled a slower approach into "restrictive territory" and maintained the prospect of a soft landing. After Powell convincingly told markets that the Fed would be willing to tolerate "some pain," suggesting a pivot or Fed put would be out of the question in 2023, we now believe that USDCAD should continue to trade at elevated levels in the near term. Considering that the Fed dropped previous language about growth concerns in their latest public comments, the risks to our USDCAD forecasts skew to the upside, especially if US inflation prints above target and induce the Fed to hike beyond the 4% handle.

LatAm

The Mexican peso was the strongest performing major currency in August, and for good reason. A hawkish Banxico reduced the pressure US rates inflicted on the USDMXN pair, as the Mexican yield curve shifted higher by 20-60 basis points across the curve, while domestic economic data showed resilience. In addition, the Mexican peso scans as the most attractive volatility-adjusted carry currency out of the Majors. Beyond broader market risk conditions, which are arguably preventing the USDMXN rate to trade structurally below the 20 handle, the main question that looms over the peso's head pertains to the rate at which inflation will continue to rise. The most recent inflation data out of Mexico saw headline prices increase by 0.7% month-on-month. While down from 0.74% in July, the pace of price growth remains uncomfortably high for most Banxico governors and supports the argument that rates will continue to rise.

While positive in nature in the near-term, the extent to which Banxico needs to hike may begin to hamper economic growth, bringing market concerns over debt sustainability and policy easing back into focus.

The strength in Brazil's real, by contrast, was a bit puzzling. Although economic indicators near the beginning of August pointed toward strength and helped boost incumbent president Jair Bolsonaro in the polls, most of the dataflow toward the back half of the month painted a picture of fundamental weakness in the Brazilian economy. Furthermore, the commodity export-heavy economy experienced a significant weakening in its terms of trade, which were previously a tailwind for the real. The prices for crude oil, soybeans, and iron all receded considerably. In terms of rates, although the BCB has been ahead of the curve in raising interest rates to fight inflation, the hiking cycle has come to an end. The Selic rate now sits at 13.75% and money markets expect them to decline as early as next year as growth conditions deteriorate, fuelled in part by the lagged impact of aggressive monetary tightening. Taking those factors and adding in a hefty dose of political risk that stems from the country's October presidential election into account, there is a recipe for a stronger USDBRL rate in the near-term, especially if the Fed continues to talk up the US terminal rate. Over the medium-term, once political risk dissipates and global economic conditions stabilise, the Brazilian real could re-emerge as the market's sweetheart.

CE3

CE3 currencies posted a bounce back against the euro toward the end of August as EURUSD rose back above parity and European energy benchmarks cooled on news that major European nations had surpassed the 70% gas inventory threshold.

Given the region's exposure to European wholesale gas prices and Europe's deteriorating economic growth prospects, however, we expect CE3 currencies to remain under pressure heading into the winter as the worst is yet to come.

Considering the levels of economic exposure to Europe's energy markets, we anticipate that the Hungarian forint will remain the worst of a bad bunch, while on the other end of the spectrum, the Czech koruna is likely to experience lower relative volatility because of the CNB's FX intervention programme. Risks to our CE3 forecasts are tilted toward further weakness in the near term as there remains scope for a larger economic contraction in Europe and the expected end to the CE3 hiking cycle may be questioned by still-rising CPI data.

FX Forecasts

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September 2022

Forecasts

Currency Pair	1-month 30th Sept 2022)	3-month (30th Nov 2022)	6-month (28th Feb 2023)	12-month (31st Aug 2023)
G10				
EUR/USD	1.00	1.00	1.03	1.10
USD/JPY	135	130	125	125
GBP/USD	1.14	1.15	1.20	1.23
USD/CHF	0.975	0.960	0.951	0.909
USD/CAD	1.32	1.30	1.26	1.23
AUD/USD	0.69	0.72	0.73	0.75
NZD/USD	0.62	0.63	0.65	0.68
USD/SEK	10.5	10.8	9.81	9.27
USD/NOK	9.8	9.6	9.22	8.55
DXY	108.8	108.05	104.37	99.58
Emerging Markets				
USD/CNY	6.9	6.95	7.0	7.0
USD/INR	79	77	75	75
USD/ZAR	17	17	16.5	16
USD/TRY	18	18.5	18.5	17.5
USD/PLN	4.80	4.80	4.56	4.00
USD/HUF	410	420	398	355
USD/CZK	24.5	24.8	23.8	21.8
USD/BRL	5.3	5.0	4.8	5.0
USD/MXN	20.5	19.8	19.5	19.0
Euro Crosses				
EUR/GBP	0.877	0.870	0.858	0.894
GBP/EUR	1.14	1.15	1.165	1.12
EUR/CHF	0.975	0.96	0.98	1.0
EUR/CAD	1.32	1.30	1.30	1.35
EUR/SEK	10.5	10.8	10.1	10.2
EUR/NOK	9.8	9.6	9.5	9.4
EUR/TRY	18	18.5	19.1	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
EUR/BRL	5.3	5.0	4.9	5.5
EUR/MXN	20.5	19.8	20.1	21.0

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