



MACRO OUTLOOK 2024

Not so fast:
Dollar to decline but rout unlikely

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EXECUTIVE SUMMARY

The general consensus amongst the sell-side community is that 2024 will be characterised by looser DM monetary policy, spearheaded by aggressive rate cuts from the Fed. This is expected to weigh materially on the dollar, primarily against low-yielding and procyclical currencies. Towards the end of last year, however, cooler inflation data and continued labour market normalisation saw markets prematurely price this outlook, with money markets implying 160bps of rate cuts from the Fed, which consequently led the dollar to fall 5% from its early November high. Given the seismic shift in the market environment in December, our 2024 outlook differs from consensus in a few key areas.

Our main off-consensus view is that we expect the US economy to outperform both the market consensus and the FOMC's forecast given most of the tightening impulse has now been transmitted through to the real economy, while temporary growth drags in Q4 such as industrial strike action and the resumption of student loan repayments dissipate. This should keep the Fed on a more cautious footing than currently priced into swaps and implied by Chair Powell's commentary at December's meeting. This view has been shared by Fed members in the weeks since. Above consensus growth should also sustain the theme of US exceptionalism, supporting the dollar as moderate growth in other major economies present little impetus for capital to flow out of the US. Against emerging markets, the stronger US growth profile should limit the extent to which duration rallies, presenting a headwind for EM currencies where central banks are committed to rapid normalisation. As a result, we expect the greenback to actually rebound from its December sell-off as early as Q1. Despite looking for a rebound in the dollar in the first quarter, we agree that macro conditions should be conducive to USD depreciation over the course of 2024 and thus look for a second year of moderate dollar weakness.

While we agree that DM monetary policy is set to loosen over the course of the next year, we believe that there will still be variation in the easing cycles. Risk of recession in Canada and the eurozone should induce rapid central bank easing, potentially as early as 24Q1. Conversely, structural factors are likely to prevent the BoE, RBA, and RBNZ from joining the easing party until the second half of the year, if at all. Sequencing in easing cycles should present relative value opportunities, especially in the early months where we expect the market to remain focused on yield differentials and decisions to ease policy are unlikely to immediately improve activity indicators. This should generate wider ranges in DM crosses relative to 2023. Our highest conviction calls on this basis is that AUD, NZD, and to a lesser extent GBP, will outperform against early easers like EUR and CAD. Furthermore, we don't just expect a less benign environment in spot markets, but also the options space where we think traders are complacent to the degree of business cycle and political risk in 2024. Key elections in Taiwan and the US, the continuation in quantitative tightening, and a large degree of macro uncertainty, specifically whether DM labour markets will continue to normalise slowly amidst slower global growth and whether China's economy can produce elevated levels of growth without further support, should generate higher levels of realised and implied volatility. Our view is that medium-term vol should pick up in the coming months as incoming macro data paints a less benign landscape than currently implied, and (geo)political risks become a more prominent concern for markets. This contrasts with the market consensus, which generally looks for vol in most major pairs to either trend sideways or grind lower as central banks ease and rate volatility subsides. Finally, we expect 2024 to be the year where the Bank of Japan finally normalises its policy stance, with an official end of yield curve control in April and an exit of negative interest rates in October. However, given the Bank's acknowledgement of the role the yen plays in imported inflation, we expect the BoJ to approach tightening in a cautious manner, potentially diluting the impact of any normalisation efforts on the yen through dovish communications. This is likely to produce more moderate USDJPY downside than some within markets currently anticipate.

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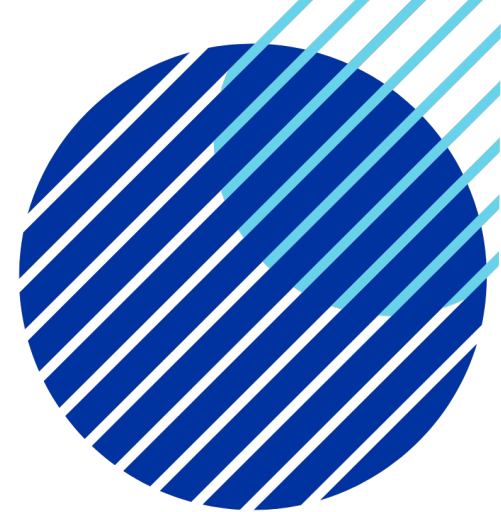
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MONEX'S JANUARY 2024 FORECASTS



2023: A year of four distinct quarters

The sell-side consensus entering 2023 was that the Fed would need to take rates north of 5% to break the back of surging inflation, and that this would likely prompt a US recession. Most also highlighted risks that the Fed broke something else besides inflation, with commercial real estate generally viewed as the main financial vulnerability. The combination of a recession and the risk of a period of financial instability meant that many analysts saw the Fed officially calling an end to their hiking cycle in 2023, with some outrightly predicting rate cuts. In Europe, having seemingly avoided a sharp contraction as gas futures cooled from their meteoric heights in 2022, consensus looked for a rebound in growth, even as the ECB were expected to hike rates further as inflation pressures remained a concern. With the US expected to fall into recession and eurozone growth to be modest at best, it was China that most were pinpointing as the driver of the global economy through 2023 after the government's abrupt exit of Covid restrictions in December 2022. Here, expectations were that the consumer would drive strong growth after a sustained period of constrained spending. A sea change in the economic framework wasn't just expected in China after developments in December, as consensus quickly formed around BoJ normalising policy in 2023 following a shock decision to expand the trading cap on 10-year yields. Taken together, this saw most sell-side analysts call for a structural decline in the dollar in 2023 as the investment outlook outside of the US proved supportive of capital rotation.

We didn't necessarily share this view, however. Under our base case, we expected the US economy to remain resilient, leaving the risk of rate cuts in 2023 as minimal. Furthermore, we didn't foresee global growth conditions troughing until the second quarter, keeping the dollar supported as the US retained a more constructive investment outlook. Nevertheless, with the bulk of the Fed's tightening cycle in the rearview mirror, we did believe front-end Treasury yields were close to their peak and that this was set to prevent the dollar returning to its 2022 highs. As a result of the limited headroom in Treasury yields and the potential for improving growth conditions in the rest of the world towards the end of the year, we thought the dollar would close 2023 moderately lower, making us less bearish than the broad consensus. That said, we expected the bulk of the dollar's downside to arise in the second half of 2023, as global growth conditions converged and discourse in markets shifted towards the timing of rate cuts. We expected much of the dollar's decline to occur against low-yielding Asian FX, which had spent the bulk of 2022 under considerable pressure due to widening yield spreads. By contrast, we believed structural inflation pressures and weak growth outlook in Europe would provide a low ceiling for EURUSD and GBPUSD.

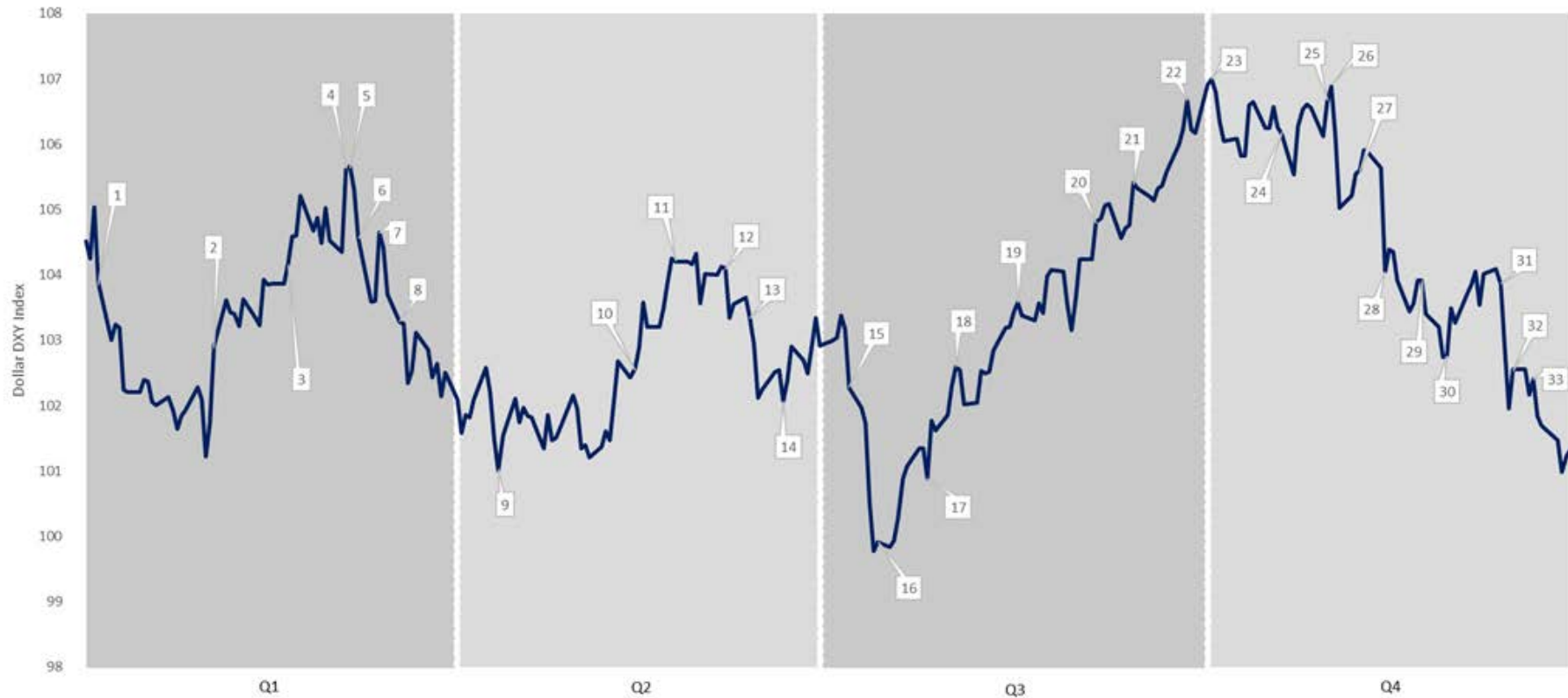
The dollar's decline proved even more moderate than we expected in our full year 2023 outlook, primarily due to greater resilience against major Asian currencies

	EURUSD	GBPUSD	USDJPY	USDCNY	DXY
Monex 2023 full year forecast	1.10	1.25	120	6.5	99.5
2023 year-end spot rate	1.1037	1.2731	141.08	7.1001	101.33

While China's economy misfired throughout the year and the Bank of Japan's efforts to exit ultra-loose policy undershot our expectations, both of which led to considerable forecast errors in the respective currencies, our view of mild USD depreciation was ultimately sustained by moderate gains in European FX and a broad sell-off in the dollar as rate cuts came into view towards year-end. Overall, the DXY index fell 2.11% on the year to 101.33, falling just short of our 99.5 forecast. While the dollar's decline proved more modest than our full-year expectations, that was by no means a reflection of a lack of appetite in markets to short the greenback. In fact, what was visible throughout the entirety of the year was the market's asymmetric bias in the dollar, with traders reacting more strongly to data and events that supported a dovish view on US rates and USD downside than the contrary. This arguably reflected the short USD consensus across 2023 outlooks. Despite the level of participation in the dollar proving asymmetric throughout the year, at points economic conditions didn't justify sharp depreciation in the dollar, namely at the start of the second and the entirety of the third quarter. In addition to the short USD bias in markets, 2023 can be characterised by four durable themes, which were almost evenly distributed across respective quarters.



The broad dollar showed four clear trends throughout 2023



- | | | |
|--|--|--|
| <p>1. US wage growth cools and ISM services PMI falls below 50, prompting bets on a lower terminal rate</p> <p>2. 500k NFP print sparks fears the Fed needs to take rates to 6%</p> <p>3. UK flash PMIs exhibit resilience</p> <p>4. Fed Chair Powell stokes speculation of another 50bp hike</p> <p>5. BoC pauses at 4.5%</p> <p>6. SVB collapses</p> <p>7. Saudi National Bank announces withdrawal of support for Credit Suisse</p> <p>8. UBS announces CS buy-out</p> <p>9. Chinese surprise index peaks</p> <p>10. Chinese industrial production data unexpectedly falls</p> <p>11. US debt ceiling stand-off</p> | <p>12. BoC resumes hiking</p> <p>13. Fed indicates 2 further hikes, despite holding rates</p> <p>14. BoE accelerates with 50bp hike</p> <p>15. Soft NFP print sparks dollar sell-off</p> <p>16. DXY records YTD low</p> <p>17. Fed hikes for last time, keeps Dec hike on the table</p> <p>18. BoE hikes for final time</p> <p>19. USDCNY hits 7.3, sparking PBoC intervention</p> <p>20. BoC hits terminal rate of 5%</p> <p>21. ECB hikes for final time with deposit rate at 4%</p> <p>22. Oil prices peak at \$94 per barrel</p> | <p>23. DXY index records YTD high on commodity inflation and risk of eurozone recession</p> <p>24. 10-year Treasury yield peaks just above 5% following duration sell-off in Q3</p> <p>25. BoJ removes hard cap on JGBs</p> <p>26. October's payrolls prints weak, sparking 2024 easing bets</p> <p>27. RBA hikes to 4.35%</p> <p>28. US services CPI cools, adding to calls for aggressive Fed easing in 2024</p> <p>29. Flash PMIs show eurozone weakness</p> <p>30. Weak eurozone CPI sparks recession concerns</p> <p>31. Chair Powell acknowledges discussion on rate cuts, sparking sustained USD depreciation</p> <p>32. Comments from Fed officials stress that an assessment of a March start of cuts is "premature"</p> <p>33. During BoJ meeting Governor Ueda cast a significantly more dovish tone than rumours had suggested</p> |
|--|--|--|

Q1: Growth and financial stability

The first quarter of 2023 saw the consensus view largely play out. Signals from Chinese policymakers increasingly pointed towards a strong reopening rebound in the economy, which in turn helped support confidence that the eurozone economy would now avoid recession as demand for exports would increase. However, optimism over the eurozone economy was tempered somewhat by concerns that China's rebound in demand would coincide with a still tight energy market, leaving the ECB with the problem of trying to dampen inflation. Nevertheless, the improving growth prospects in the eurozone and China saw markets rotate out of the dollar and into currencies within China's sphere of economic influence.

That was until the US economy delivered the first major surprise of the year. February's nonfarm payrolls report saw a monster 500k jobs added, fuelling fears that the Fed may have to tighten policy much more than previously expected. The jobs report also caused concern at the Federal Reserve, with Chair Powell suggesting that it indicates a higher terminal level for rates than previously anticipated, while he also suggested that if this economic strength was reflected across the totality of data, the Fed would need to reaccelerate the pace of its tightening.

The accompanying rise in Treasury yields, however, rapidly brought this speculation to an end. The erosion of collateral value saw several regional US banks collapse in short order. The view that this phenomenon was contained in the US and would usher in earlier easing in Fed policy saw markets sell the dollar despite overall risk sentiment cratering. That was until financial stability concerns crossed the Atlantic at the cost of Credit Suisse.

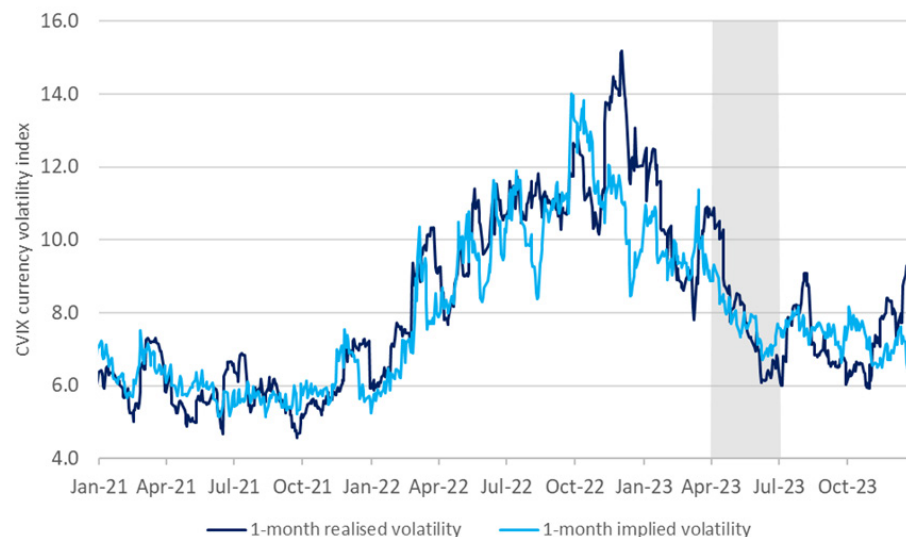
“With the global tightening cycle now taking down a GSIB, markets halted their rotation out of the dollar, although this proved only temporary as policymakers across Europe rushed to assure markets that this was in fact an isolated occurrence.”

Words of affirmation were followed by action, with the ECB leading the charge and raising rates by 50bps, in line with its previous guidance, despite concerns over the stability of the banking sector. The one significant exception however was the SNB, which undershot expectations to deliver just 25bps of policy tightening where 50bps had been widely expected, a move that saw EURCHF flirt with the idea of breaking back above parity at the end of March. Against consensus, however, emergency measures by the Fed and the SNB proved sufficient to contain the incipient crisis. As such, the dollar closed the first quarter lower as markets continued to eye better growth prospects outside of the US.

Q2: Coordination

The dollar's move lower through the end of Q1 continued into the second quarter, as rate differentials continued to narrow. With most developed market central banks hiking in synchrony, and a commitment to ongoing policy tightening remaining broadly open ended across the board, there was little differentiation in monetary policy stance for markets to trade in early Q2. This saw G10 FX volatility crater, forcing attention onto emerging markets.

Having appeared to stabilise in Q1 2023, both implied and realised currency volatility across G10 FX dropped sharply in Q2



The result of reduced market volatility and lower Treasury yields was outperformance across high yielding EM FX. In particular, LatAm currencies such as the Mexican peso and the Brazilian real, alongside CE3 FX, notably outperformed, with spot gains of around 5% over the quarter despite a backdrop of a broadly stronger dollar. That said, though it perhaps wasn't quite so obvious at the time, the months leading up to summer also saw two key developments take place that set the scene for the rest of the year.

First, the long-awaited Chinese reopening began to stall out, with April seeing the peak in the economic data surprise index, though it was a soft set of industrial production data published mid-May that really saw this accelerate. With growth concerns elevated in DM markets, the Chinese reopening boost looked good in comparison, though the slowing data was a harbinger of what was to come later. Second, from May onwards, the US debt ceiling came

into focus for FX markets. With congressional negotiations seemingly stalled, the dollar rallied on a haven bid. Whilst the Treasury had been engaged in extraordinary measures since January, running down the balance of the Treasury General Account, there was hope that a flurry of tax receipts would ultimately leave a potential government default a Q3 problem. However, increasingly dire warnings through May made it clear that the US government was likely to run out of headroom far sooner than that, with a likely drop-dead date looming in early June. It was with some relief then that a deal was finally agreed between President Biden and House Speaker McCarthy, which saw some of the defensive dollar positioning unwind. However, this was a harbinger of what was to come, which was consequential for yields. Continued political infighting saw ratings agencies either downgrade the status of US debt or issue warnings. In combination with the Treasury needing to replenish the TGA, this set the scene for higher yields in Q3.

Q3: No challengers for the dollar

Whilst the broad dollar bounced around in a 5% range in the first half of the year, the third quarter saw a more durable trend play out. The dollar broadly rallied alongside Treasury yields under the Fed's credible "higher for longer" narrative and concerns over the trajectory of the US deficit. Despite this, the first few weeks of Q3 actually started with a sharp sell-off in the greenback after June's payrolls report modestly undershot expectations and was followed up by a soft inflation reading just 5 days later, with core inflation cooling to just 0.2% MoM. The 3.5% drop in the broad dollar over this period was the first real indication of the market's appetite to sell the dollar on the end of the Fed's hiking cycle. On this occasion, however, the dollar's decline set the base for the broad rally that was set to ensue.

As mentioned, the rally in the greenback was primarily a result of developments in US rates, however, it wasn't just front-end rates that markets focused on. While weakness in Chinese and eurozone growth data led to a widening in front-end differentials, which sparked the greenback's rally, it was the back-end of the Treasury curve that propelled the dollar higher over the course of Q3. Strength in the US economy, primarily the consumer, forced markets to buy into the Fed's "higher for longer" narrative. This generated speculation that the longer-term neutral level of interest (r^*) was higher than initially believed. In combination with increased Treasury issuance and concerns over the US debt trajectory, a higher longer-term neutral rate propelled yields on the 10-year above 4.5%, with the sell-off in duration weighing on sentiment in equities and engagement in EM carry positions, both of which supported the greenback.

The trend higher in the dollar persisted across the entirety of the third quarter, with the DXY index rising above the 106 handle. In fact, the dollar's

peak would have been higher if it weren't for the introduction of soft currency pegs in China and Japan. In retrospect, the fact that the upwards momentum in the dollar wasn't impaired by the Fed's decision to hold rates for the second time this tightening cycle in late September was notable, especially as the hold precluded a lower terminal rate than markets were implying. At the September meeting, policymakers didn't just unanimously vote to keep rates on hold, but they also left their longer-run projections unchanged at 2.5%. Together this pushed back on the prospect of a higher short-term and longer-term r^* , a dynamic that if supported by incoming data would put a halt to the climb higher in Treasury yields and the dollar.

Q4: Finding the peak

Almost on cue, the dollar rally began to run out of steam as the fourth quarter began. The soft pegs in the Japanese yen and the Chinese yuan prevented the broad dollar from grinding higher, while speculation that the tighter financial conditions would ultimately substitute for further Fed tightening saw back-end Treasury yields struggle to break through 5%. However, with the US economy continuing to generate resilient growth which in turn supported concerns over inflation persistence, the path lower for the dollar appeared narrow. From November onwards, however, both inbound data and economic events elsewhere were the right temperature for markets to begin speculating on the Fed's easing path in 2024 and short the US dollar.

First, the PBoC delivered on long-running speculation, announcing a 1tn yuan fiscal support package - all but guaranteeing that Chinese authorities would meet their year-end growth target of 5%. Second, the BoJ removed a hard cap of 1% on the 10Y JGB, the key anchor in their yield curve control framework. Whilst the initial market reaction was to take the yen higher, subsequent acknowledgement that this was one step closer to full policy normalisation saw USDJPY trading back down into the 140s. Third, leading indicators in the eurozone suggested the region's growth outlook was starting to improve. This saw most major currencies rally against the greenback as investment opportunities eventually arose outside of US capital markets. The key factor underpinning the dollar's sell-off into year-end, however, was domestic developments. Despite the dollar holding its ground in October, November brought with it a redux of July's price action, with markets once again attempting to front-run the Fed in response to a modest softening in the data. Momentum lower in the dollar was sustained throughout December as Treasury yields continued to slide from their highs, with the dovish view on US rates arguably validated by Chair Powell delivering the first concrete signs of a Fed pivot at December's meeting. All told this saw the DXY index fall to levels not seen since July as markets priced rapid policy easing from the Fed in 2024, however, we think markets have gone too far too quickly, with price action not consistent with current economic conditions.

2024: A less benign year than markets are pricing

The end of 2023 saw markets price an aggressive easing cycle for the Fed in 2024, leading to a sell-off in Treasuries and a stock-market rally. However, we think the current cross-asset environment is in an unstable equilibrium. Specifically, we see it as highly unlikely that the Fed cuts rates as fast as money markets are pricing under our expectation of an acceleration in the US economy. If realised, this should see global capital flow back into US assets, enabling the dollar to retrace losses experienced towards the end of 2023. On the contrary, should the US economy continue to slow and endorse the market's implied path for rate cuts or even amplify the pace of cuts, we think the path that the macro data needs to traverse to continue being USD negative will remain narrow; any sign that the economy is cooling quicker than suggested under a soft landing is likely to spark a USD haven bid given weak growth conditions in the rest of the world.

“Put another way, we expect the margins of error for the data to confirm the current market base case in early 2024 to be large, with any misses in top-tier US data likely to prove USD positive in the short-run.”

As a result we expect something to give as early as 24Q1. Either market pricing of the Fed's easing cycle is reined back in or markets need to begin pricing a less benign outlook for risk assets in 2024.

Under our base case we expect the US economy to reaccelerate from its 23Q4 slump to produce growth above the economist consensus (1.3%) and anticipated by the Fed (1.4%). With real GDP growth closer to 2%, driven in large part by strength in the labour market and real wage growth, we expect the Fed to take a more cautious path on rate cuts in 2024 than the cumulative 160bps priced by markets at the turn of the year. This view has been shared by Fed officials since December's meeting. With growth conditions weak in other major economies, and in some instances so weak that it ushers in earlier rate cuts from their respective central banks, we expect the US activity data to support the dollar through a slight re-widening in front-end rate differentials against select DM peers and better fundamentals.

Where we see the greatest near-term divergence is in Canada and the eurozone, where the Bank of Canada and the European Central Bank are more likely to meet the market's stretched expectations of easing as growth conditions continue to deteriorate, suggesting policy may have been initially overtightened to combat inflation. Unlike in early 2023, expectations of a growth surge in China are unlikely to come to the rescue too, with activity data yet to show a material pick-up despite the various support mechanisms unveiled throughout 2023. Overall, this environment of relative US growth outperformance and challenged yields elsewhere should make sustained downside in the dollar difficult to engineer, even as history

suggests that the imminent commencement of a Fed easing cycle durably weighs on the dollar against procyclical assets. Our conviction in this contrarian bullish view on the broad dollar has only increased in recent weeks, with entry levels into tactical USD longs only improving amidst an unchanged macro backdrop.

“Over the medium-term, the overall environment of weaker growth and cooler inflation should, however, result in rate compression as central banks pivot from synchronised tightening to easing.”

That said, the determinants of each easing cycle are likely to be varied, with faster easing cycles motivated by recession and financial stability risk and more moderate easing driven by concerns over inflation persistence, largely from the labour market. Differentiation in the sequencing of easing cycles should offer relative value opportunities across both DM and EM spaces respectively, both against the dollar and on crosses.

Furthermore, with rates spreads now compressing, we expect markets to become more sensitive to a broader array of fundamentals, such as valuations, growth rates, and prospective capital returns as opposed to largely focusing on interest rate pick-up. Alongside the re-emergence of election risks, growing tensions between the US and China, and other factors we lay out in our key themes for 2024, we expect most currencies to trade in wider ranges and experience heightened levels of implied and realised volatility on average.

THEMES FOR 2024

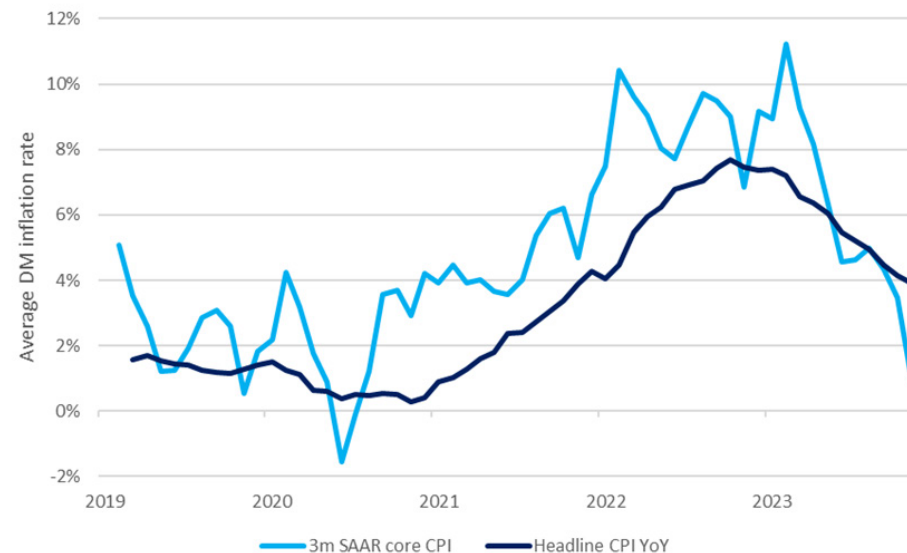
Looser monetary conditions

Undoubtedly the main theme for markets in 2024 will be the pace and sequencing of monetary easing. While this has already commenced across the EM high yielders, where central banks reacted more swiftly to upticks in inflation, 2024 is set to be the year where most DM central banks also begin to ease policy back to or potentially below neutral levels seeing as the average pace of underlying DM inflation is back below 2%. While we expect the easing cycle to be somewhat synchronised, we don't expect central banks to move in sync, similar to the start of the tightening cycle. Structural factors and growth conditions are likely to generate dispersion in the pace of easing. For example, high levels of immigration in New Zealand are likely to keep the economy running hot, boosting demand in the short-term before the increase in potential output is realised. This should see the RBNZ remain somewhat reluctant to ease policy throughout 2024 despite having been the most aggressive central bank during the tightening cycle. Furthermore, a lower relative terminal rate and a tight labour market should also prevent the RBA from easing until late-2024, while the Bank of England will likely also find it more difficult to ease policy despite a stagnant economy due to structural supply constraints.

“At the other end of the spectrum, weak growth rates and signs that slack is reappearing in their respective labour markets will likely prompt the ECB and BoC to be amongst the first DM central banks to ease.”

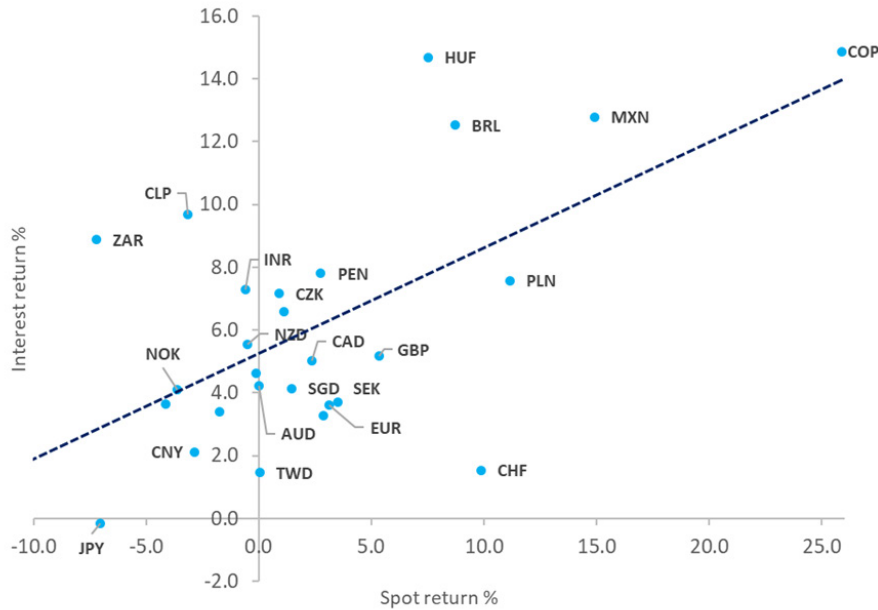
In the middle of the two extremes we find the Federal Reserve and the Swiss National Bank, both of which have managed to engineer soft landings to differing degrees. With inflation likely to fall back to the Fed's target by Spring and the labour market show further signs of normalising, we expect the US central bank to begin cutting rates in Q2 in a front-loaded fashion. Meanwhile, for the Swiss National Bank, looser monetary policy from the ECB, a more benign external inflation backdrop and weak growth conditions on the continent should see the central bank pivot towards easing policy rates and pushing back on excessive CHF appreciation.

The aggregate pace of core inflation across developed countries has now fallen back below 2%



The commencement of the DM easing cycle will have three major implications for FX markets. Firstly, rate spreads between the US and the rest of the world will continue to compress over the medium-term given the Fed outpaced most DM central banks during the hiking cycle and policymakers continue to view the longer-run rate of interest at 2.5%. While we argue that this is unlikely to occur in the short-run, it is likely to take place from 2H24 onwards as the Fed's easing cycle becomes more established and inflation continues to track at the target level. All told, this should weigh against the dollar against low yielding currencies that took the most punishment during the Fed's tightening cycle, alongside procyclical currencies as looser global financial conditions lift cyclical optimism. Second, with central banks starting to ease policy across the board, carry is likely to become a less dominant theme for markets to trade, forcing a reassessment of valuations, especially amongst those currencies that previously had high levels of carry yet weak fundamentals such as CAD, stretched positioning (MXN and BRL) and funding currencies (Asian FX).

Outside of idiosyncratic cases (ARS, TRY, RUB), higher yielding currencies generally outperformed across 2023

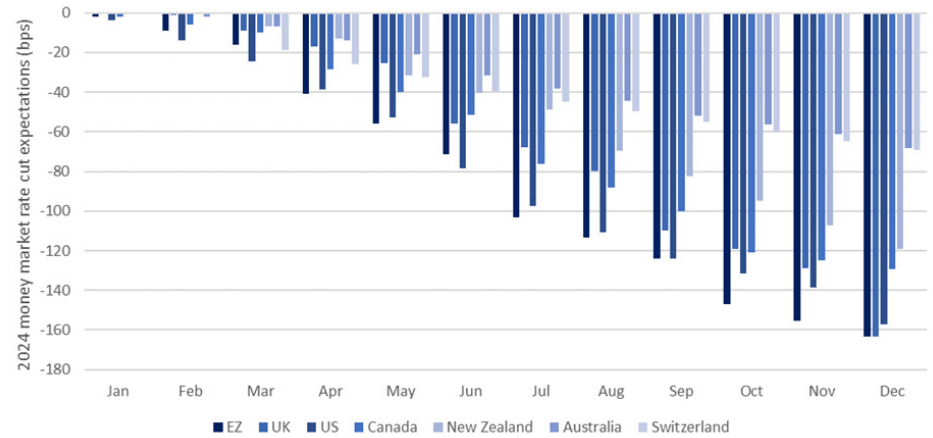


Third, the varied pace and motivation of rate cuts is likely to cause dispersion amongst returns, both against the dollar and on crosses. We expect this to be a prominent theme during the early part of the easing cycle as central bank actions are likely to reflect varying cyclical factors, with the first out of the gate to cut rates likely motivated to do so by recession concerns.

“Heading into 2H24 when central banks experiencing soft landings also join the easing trend and early movers start to see the growth benefits of looser monetary conditions, we think carry will play a much narrower role.”

The impact of diverging central bank expectations started to become visible towards the end of 2023, leading to significant moves on crosses like GBPEUR and EURNOK. However, there still remains a significant amount of synchronisation priced into DM rates relative to our central bank base cases.

Expectations of DM easing cycles in 2024 shows some degree of variability, but we expect further dispersion



BoJ going the other way

While DM central banks start to look towards loosening the restrictive policy they have placed on their respective economies within 2024, expectations remain that the Bank of Japan will buck the trend and continue to exit ultra-loose monetary policy as inflation pressures embed back into the economy after a lengthy hiatus. This is even as the BoJ consistently undershot consensus expectations in 2023 despite inflation pressures tracking above the Bank’s 2% target. Nevertheless, we think the BoJ’s actions over the past year have set the stage for an eventual exit of ultra-loose monetary policy conditional the Spring wage negotiations support further domestic inflation. While Governor Ueda’s commentary at December’s meeting suggests an outright hike in the policy rate as early as April is unlikely, with the Bank looking to witness the passthrough of wage growth to realised inflation in components such as services, we think the BoJ will fully exit its yield curve control framework at this point. This will provide a window to observe market functionality before raising rates, which we now expect in October. If realised, we expect BoJ normalisation to deliver sustained JPY appreciation, a view that most have held since the start of 2023. Furthermore, the reluctance by policymakers to provide forward guidance on this should see speculation over policy action remain elevated over the next year, potentially spurring a broader uptick in implied volatility across the majors. Outside of the obvious risk that the BoJ doesn’t normalise policy due to uninspiring wage developments, the main risk to our view on the yen is that the BoJ applies dovish spins to each tightening decision, as was the case throughout 2023.

Financial stability concerns to remain but focus will be on growth impact

Given the importance of the global tightening cycle over the past 18 months, concerns over financial stability are likely to remain - even as the first real stresses that emerged with the regional banking crisis in the US and the subsequent collapse of Credit Suisse didn't cause the kind of systemic blow up that keeps traders up at night. By most accounts the more opaque parts of the financial system that warehouse risk outside of the banking sector remain the area of concern, especially if DM rates are held in the 3-4% range for a sustained period of time. However, given the tightening cycle has largely concluded across major economies and financial conditions are set to loosen, if only at the margin, the threat of financial instability is likely to be a slower burning dynamic than a sudden jolt that rocks the financial system.

“As such, financial stability concerns are likely to have a greater impact on growth as opposed to increasing overall market volatility.”

Private assets, particularly credit, look vulnerable once again at first glance. In short, deals that made sense with policy rates at the effective lower bound look a lot less attractive if central banks now need to maintain interest rates in a higher range. However, with private asset investors facing less pressure than some other market participants to mark-to-market, and little incentive to do either, this does not appear to be an acute risk at present. Though this may weigh on activity in parts of the sector through the year, it also opens up opportunities too. In particular, distressed credit and restructurings may well benefit from the pressures imposed by higher rates, even as other strategies fall out of favour. As such, whilst the sector continues to hold the potential to spark a blow up in 2024, we think this is less likely to arise than it was in 2023.

Real estate too is an obvious suspect, with housing markets across many developed markets looking overvalued. That said, this is arguably for good reason, particularly across the English-speaking world. A combination of high immigration and burdensome red tape means that structural supply shortages should continue to keep prices supported, even in the face of headwinds. Moreover, with prices having rallied strongly over recent years, many homeowners now find themselves with a price buffer to absorb any short term normalisation in prices. This notably played out in Sweden over 2023, where a 15% retracement in the property market did not herald a more persistent down-turn in real-estate, but rather a post-Covid normalisation of an otherwise overheated market. Absent an outright market collapse, it appears more likely that declining real estate prices weighs on the consumer, and therefore growth at the margin, rather than posing a significant risk to financial stability in the near term.

That said, whilst the former two risks have garnered a lot of attention, over the past year, there have been some overlooked dynamics too. One has been the lack of corporate insolvencies since the onset of the Covid-19 pandemic. Initially this made sense as widespread and indiscriminate government support served to keep firms afloat that would otherwise have been forced out of the market. But with this support now being withdrawn and financial conditions generally tighter, zombie firms that survived on cheap credit and government help should find themselves under increased pressure in the next twelve months. Though this is unlikely to present the same kind of systemic risk as private assets or real estate, it does pose a downside risk to the growth outlook across developed markets nonetheless. The other overlooked dynamic has been the ongoing reduction in liquidity in the financial system, due to both higher interest rates and thus credit creation alongside quantitative tightening efforts. While 2023 saw cameos of the problems this poses within the bond market specifically, over the medium-term this is going to be a more pressing concern for financial stability as a whole. The outcome of which could lead central banks to abruptly halt the reduction of their balance sheets, accelerate easing plans, or in a worst case scenario supply emergency liquidity to the system through quantitative easing. If this financial stability concern materialises, we expect it to not only have an impact on the real economy, but also directly on financial markets, leading to an uptick in realised and implied volatility.

Increased (geo)political risks

If 2022 highlighted the risks posed to the global economy from relatively contained regional conflicts, 2023 offered a counterpoint with the outbreak of hostilities between Israel and Hamas having minimal impact for markets outside an immediate sell off in the Israeli shekel. Moreover, whilst the war between Russia and Ukraine continues, this winter is yet to see a repeat of last year's energy crisis that sent inflation spiking across the global economy and particularly in Europe. That said, with two major conflicts to contend with in addition to domestic political concerns, a post-pandemic recovery and the green transition, American state capacity has looked increasingly stretched throughout the last year.

“One consequence of this, at least in part, has arguably been rising tensions across multiple regional flashpoints around the globe.”

This peaked towards the end of the year where conflict in the Middle East intensified further with Iranian backed Houthi rebels in Yemen disrupting shipping through the Suez Canal, risking disruption to supply chains that have only just recovered post-Covid.



The most significant by-product, however, has been the freer hand afforded to China. Whilst China only utilised this through sustained military activity in the Taiwan Strait and a clash with the Philippines over the Spratly Islands, there remains a risk that unification with Taiwan becomes a more pressing agenda in 2024. Though an outright invasion remains unlikely in our view, the consequences of such an event would be seismic. Given repeated statements by President Biden, US intervention seems all but inevitable if China were to attempt seizing Taiwan by force, an outcome likely to draw in other US regional allies too. As such, the associated disruption to global trade would not just be limited to semiconductors, but rather, risks the kind of breakdown in supply chains that makes the difficulties of the last two years pale in comparison. Aware of these potential consequences, we expect that leaders on all sides will be wary of escalation, as has been visible in the recent attempts to rebuild military cooperation between Presidents Biden and Xi.

“That said, elections in both Taiwan on January 13th and the US in November pose a notable risk.”

In Taiwan, both re-election for the incumbent DPP party under its new leader William Lai or the change in office for the opposition KMT poses risk for geo-political instability and market volatility. Although a DPP re-election would mark a continuation in governance, this is far from guaranteed with Lai's vocal support of independence, which could spark a military response from China. Furthermore, while a transition to a KMT government would likely lead to an immediate de-escalation in tensions, a Taiwanese government more closely aligned with the CCP presents the reverse risk, that Chinese authorities see this as moving in favour of reunification and act accordingly. Again, while voluntary reunification is unlikely, the risks posed will likely warrant greater US attention in the region, leading Taiwan to be a key election issue in the US presidential election and posing the potential for a direct clash between the two global superpowers.

A number of elections pose risks for markets in 2024

A number of key elections are set to take place outside of Taiwan this year too, with the most significant being the US presidential election in November. At present, this looks likely to be a rerun of the 2020 race, with opinion polls predicting a second showdown between incumbent President Joe Biden, and former President Donald Trump. While a repeat of the 2020 election suggests this should be a more familiar election cycle for markets to trade, there is a risk that an independent candidate induces more uncertainty in the outcome. This time around, Robert F. Kennedy Jr. has emerged as a potential spoiler candidate, with the likely beneficiary of his participation currently unknown.

Whilst both candidates are yet to announce their election pledges, it is fair to assume that the outcome of the next vote will be deterministic for the US economy and geopolitical relations. When it comes to China, Biden, whilst still hawkish, has taken a notably more conciliatory tone than Trump, and has led significant efforts to ease tensions in recent months. A victory for Trump would thus likely see markets pricing in renewed risk of a US-China trade war in our view, with the risk of further tariff hikes set to see the dollar strengthen on net in such a scenario. As such, we suspect a Trump victory would be marginally more supportive for the dollar than maintaining the status quo. Outside of China, a few other considerations will also be top of mind for FX markets. These mainly concentrate on the strength of the dollar, the role of fiscal policy, and trade. On the first of these, Trump was notable in his first term for advocating a weaker dollar in order to boost US competitiveness. Though he later rowed back on this in the run-up to the 2020 election, we suspect that this preference for dollar weakness remains, and could weigh against the greenback strengthening in response to trade tensions. Regarding government spending, both candidates have to date advocated policy positions that imply fiscal expansionism, though with the US already running a significant deficit and much higher rates than seen pre-Covid, there appears little room for further large fiscal giveaways similar to Trump's previous tax cuts or Biden's Covid stimulus package. As such, with both candidates likely to pursue broadly similar fiscal spending paths, neither the Fed nor the dollar looks set to gain a helping hand from whichever presidential candidate wins on this score.

Finally, when it comes to trade, risks for FX markets are broader than just the aforementioned US-China relationship - though this is still set to be the most important dynamic. With both Trump and Biden set to pursue broadly similar American first policies, this has sparked fears of tit-for-tat tariffs being reintroduced between the eurozone and the US, with this already beginning to have an impact for markets. Given this risk, policymakers on both sides of the Atlantic recently agreed to extend a suspension of Trump administration tariffs on aluminium in late 2023. In our view a Biden victory would likely be more positive for US-EU relations and trade, though both candidates still pose downside risks. Other countries, however, may well stand to benefit, in particular those emerging markets seen as potential destinations for friendshoring supply chains, in particular for Mexico and parts of the APAC region, which could see upside across select EM FX.

“Beyond the US, the UK will also likely see a consequential election in 2024, though here it appears much easier to predict the winner.”

With the Labour Party currently holding a 15-20pp lead in opinion polls, it appears less a question of Keir Starmer becoming Prime Minister, but rather how big his majority is set to be, and what might he wish to do with it. Though a full manifesto is yet to be unveiled, what has been announced to date has been a mix of relatively centrist policies, with little of the radicalism that defined the Corbyn years. This has been sufficient to assuage market concerns for now, although the details of any policy platform are likely to be key. Even so, following on from several years of Brexit stoked uncertainty in UK politics, the prospect of a stable government may well prove a boon for sterling.

“The other notable elections scheduled for this year are all set to take place in emerging markets, and will likely be key considerations for traders of the respective currencies over coming months.”

A key theme across all these countries is the risk of political unrest and violence, a dynamic that poses downside risk to the respective currencies in 2024. That said, in India at least, a general election looks set to deliver another victory for the incumbent BJP, and as such is likely to represent

business more or less as usual for markets. The main question here is again how strong the mandate the incumbent government will achieve. Similarly, the current ruling Morena party looks set to claim victory in Mexican elections, though polls are close enough that some uncertainty over the outcome could weigh on the peso at the margin. In contrast, the likely result is not entirely clear cut in South Africa, with the ANC potentially set to lose sole control of power for the first time since the end of apartheid, an eventuality that could see power sharing with the EFF - and one that would almost certainly hurt the rand. Finally, Indonesia is set to play host to a three-way race to find a successor to Joko Widodo, the outgoing president. Though with all three hopefuls running largely as continuity candidates at present, the impact for the rupiah will likely have to await emerging policy details.

A less benign year than options markets are projecting

Slowing global inflation and progressively looser financial conditions have materially weighed on implied FX volatility heading into 2024, with the outbreak of war in the Middle East even proving insufficient to change the more benign view priced into the options space over the medium-term. Granted central banks across most of the major economies are set to ease policy over the course of 2024, which should improve cyclical conditions, risk appetite, and reduce hedging demand through options. However, we think markets are placing too much emphasis on this, ignoring the macro and political risks that could unfold in the coming twelve months. This leaves long vol strategies relatively cheap.

“In terms of the macro risks, implied volatility across DM currencies generally suggest that much of the adjustment pain from the synchronised tightening cycle is in the rearview mirror, however, we think there remain considerable uncertainties.”

The main one is the response of the labour market. Having been slower to normalise than inflation, resiliency in the labour market has underpinned soft landing projections and prospects for a better overall risk environment in 2024. However, with growth conditions set to trough in the coming months, a rapid unwinding in the labour market could pose a risk to the income-led recovery in growth that is expected in 24H2. As previously mentioned, macro risks are also presented by quantitative tightening efforts, which remain subject to a heavy degree of uncertainty and pose the risk of increased rate and thus FX volatility.

Outside of macro considerations, the 2024 political agenda could also throw up some wildcards. While the impact of most elections over the upcoming year are likely to be local, ballots in both Taiwan and the US have the potential to have broader macro and geopolitical implications (as discussed above).

“While this will likely have broad market implications, the risk in the options space is pronounced given the market is heavily positioned short volatility in the FX space, especially relative to alternative asset classes.”

We are therefore more cautious on short vol positions at current levels going into a year with plenty of business cycle and political risks.

Options pricing shows a market that is braced for one of the most benign years in recent history



CURRENCY PREVIEWS

USD

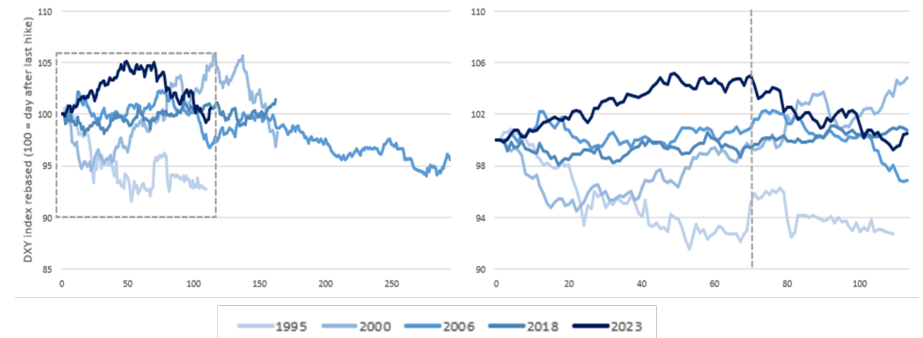
Still living in a strong dollar world

Up until late-August, the broad dollar traded lower year-to-date more often than not, even as the Federal Reserve continued to tighten monetary policy. This was largely a result of markets underpricing the Fed's hawkish resolve and the strength of the US economy. As the relative exceptionalism of the US economy became clear and validated the Fed's "higher for longer" policy stance in Q3 and the early part of Q4, this changed and the dollar embarked on a sustained period of appreciation. Over this span, the greenback's gains were broad-based, with even high yielding currencies coming under pressure from rising real rates and longer-dated yields. Shortly afterwards, however, the US consumer began to show signs of fatigue as excess savings were depleted, the full effect of tighter financial conditions was felt, and mandatory student loan repayments resumed. Corresponding with further normalisation in the labour market and sustained progress on disinflation, the discourse in markets soon shifted away from the potential for a Q4 rate hike and towards the Fed's 2024 easing cycle, to the dollar's detriment.

"While history favours a weaker dollar once the Fed officially announces the end of its hiking cycle, with 160bps of rate cuts priced, we think markets are once again underappreciating the US economic growth outlook and the Fed's hawkish resolve in 2024."

We expect this to become visible as soon as Q1, with incoming macro data likely to materially increase the risk of recession in the eurozone, sustain growth concerns in China, and paint a more resilient picture in the US. This should force markets to reassess expectations for DM central bank easing throughout the upcoming year, leading to fewer rate cuts being priced for the Fed and a rewidening in rate differentials. Nevertheless, we don't expect this time of macro reckoning to be as pronounced as it was in the third quarter as the commencement of the Fed's easing cycle, albeit at a later date than currently priced, will limit the extent to which yield spreads widen and risk conditions falter. We expect the dollar's rebound in the near-term to be most pronounced against cyclically vulnerable currencies.

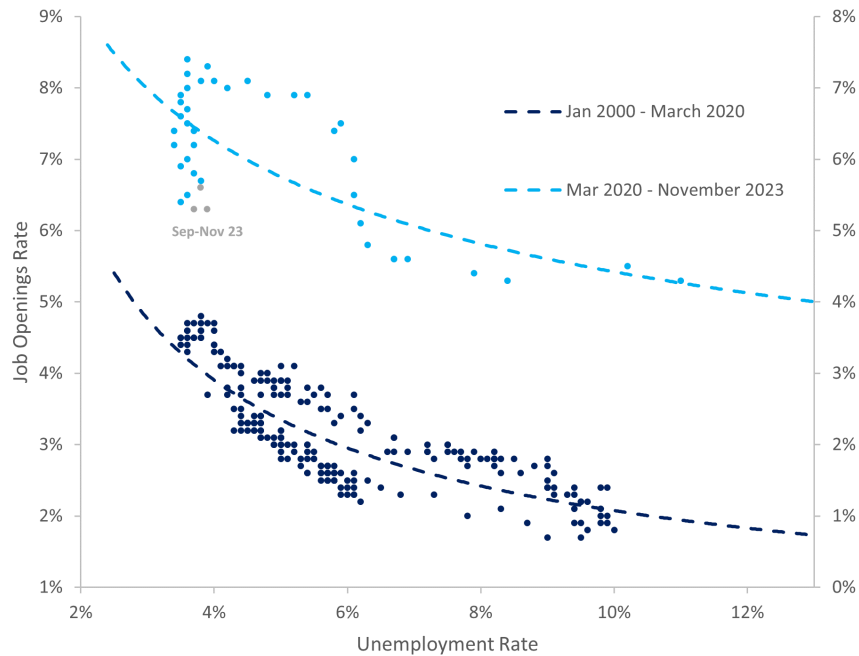
The dollar historically depreciates after the Fed's final hike, but the pronounced sell-off in the broad dollar since the Fed officially called an end to its hiking cycle presents scope for a retracement



US economy to produce above consensus growth in 2024

When most sell-side 2024 outlooks were published in November, consensus was looking for growth of around 0.9% this year, but this has since aligned closer with the Fed's forecast of 1.4%. However, this is still too pessimistic in our view and largely reflects expectations that a significant monetary drag is still to be transmitted to the economy and consumption growth is set to continue cooling as household disposable incomes recover at a slower pace. In other words, economists are expecting the Q4 slowdown in growth to be sustained throughout the year. However, we think growth in the fourth quarter was weighed down by the peak transmission of the tightening cycle and temporary factors such as the resumption of student loan repayments, the effects of which should fade in the coming months, especially considering the recent loosening in financial conditions. Our above-consensus view on growth is also a reflection of the strength in the US labour market, which should continue to support strong consumption growth. While the labour market has normalised throughout 2023, labour demand and job creation remain elevated. By our estimates this should support a recovery in household disposable income through higher levels of overall employment and real wage growth in the region of 1-1.5%. This is consistent with the message from business surveys. Although some point to excessively low savings rates and a depletion of the excess savings accumulated over the pandemic as a reason to take a more pessimistic view on growth, we think this reflects the limited need to save for both precautionary and retirement reasons given low layoff rates, elevated levels of household wealth, and negligible recession risk. As such, it is likely to rise in the near-term and constrain consumption.

While the US labour market is normalising, conditions still remain conducive towards strong nominal and real wage growth in 2024



Strong growth should delay the Fed easing cycle

With growth data set to exceed consensus expectations throughout the first quarter and inflation still tracking above target by a considerable margin, we don't expect the Fed to cut policy rates in early 2024, contrary to market pricing. In fact, we don't expect the Fed to cut rates until May once year-on-year core PCE has fallen into the low 2% range. Thereafter, softening inflation data and a further progress on labour market normalisation will likely support a rate cut at every meeting before policymakers slow to a quarterly pace of 25bps cuts in Q4. This would see the Fed cut rates by a cumulative 125bps under our base case, undershooting market expectations by just over a full hike.

Uncertainty over the timing and magnitude of our projected easing path is high, however. This is driven by the outsized impact small differences in the data outturns during the easing cycle will have on the Fed's near-term

decisions, as will the corresponding market reaction. For example, should inflation fall below 2%, the Fed is likely to cut rates faster and by a larger extent than we anticipate, while any uptick in the pace of underlying inflation will likely prompt a period of pause from policymakers. Additionally, the Fed's reaction function is likely to depend on market conditions, with any undue easing in financial conditions likely to prompt pushback from the Fed through a slower easing path.

Stronger growth and a delay in easing rates should support the dollar in Q1

Data highlighting greater resilience in the US economy and supporting a more cautious Federal Reserve should see capital flows back into the US in Q1, especially given weak investment prospects in other major economies such as the eurozone, China and Japan. By our estimates, this should see the dollar DXY index retrace its December slump, with gains most prominent against currencies with weak cyclicals. While we expect the dollar to rebound over a tactical horizon, we don't foresee the DXY index retracing back to its 23Q4 peaks, given both volatility in and the level of US rates are unlikely to return to their fourth quarter heights, while speculation of BoJ normalisation in Q2 should also provide a lower ceiling on USDJPY.

Fed easing and better global cyclical conditions will lead the dollar moderately lower in the medium-term

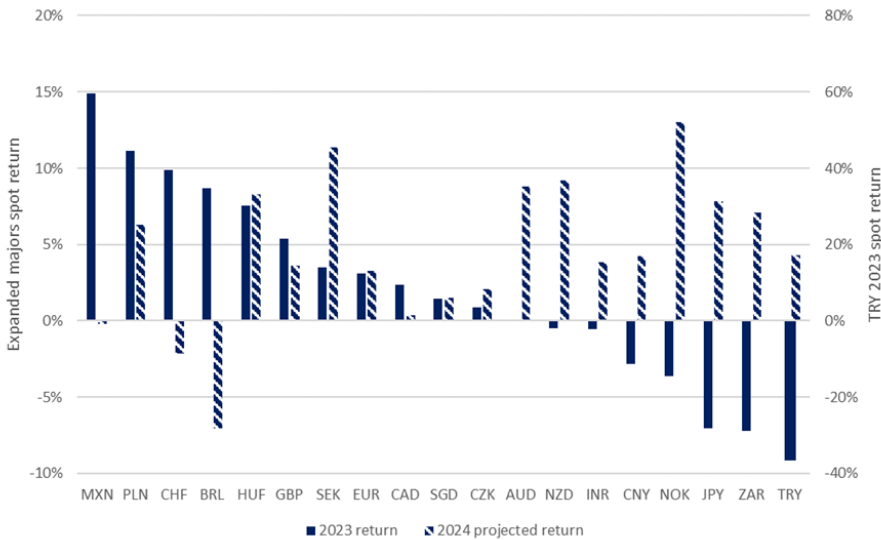
While we enter 24Q1 with a bullish bias on the dollar, our medium-term view is less constructive. The greenback currently scans as overvalued relative to its fundamentals, and while in the near-term this can be justified by weak investment prospects outside of the US and a re-widening in rate differentials, we expect this support to fade heading into Q2 as the imminent start of the Fed's easing cycle weighs on front-end Treasury yields and earlier easing by peer central banks narrows the US-G10 growth differential. This should materially improve the cross-asset risk environment, weighing on the dollar on a broad basis.

“Despite predicting another year of moderate USD depreciation, once against loaded towards the second half of the year on an uptick in global growth conditions, we think 2024 will produce markedly different returns across the expanded major's complex against the dollar.”

Unlike the past year, punitive valuations and carry erosion are likely to prevent another stellar year for EM high yielders. In combination with lower Treasury yields, this should support funding currencies, specifically those within Asia

that are now subject to cheap valuations. Furthermore, despite our concerns over the extent to which China can sustain elevated levels of growth without continued policy support, looser financial conditions globally and above-consensus growth in the US should support procyclical currencies such as ZAR, NZD, and AUD. For both Antipodean currencies, slower central bank normalisation should also provide a tailwind. Under our base case, this should see AUD and NZD rank as some of the best performing G10 currencies, improving on a middling performance in 2023.

Returns against the dollar is likely to be more varied in 2024, with cyclical assets and low yielders likely to outperform



November's Presidential election could be a wildcard for the dollar

At present November's Presidential election looks set to be a re-run of the 2020 race, seeing the incumbent Joe Biden face off against his predecessor Donald Trump once again. Whilst this is set to offer a source of uncertainty for markets throughout the year, our early view is that the election will prove net positive for the dollar in both outcomes.

Central to our view is the attitude of both candidates towards trade, with Biden and Trump offering similar versions of an America first approach, albeit to differing degrees. The risk of more protectionist interventions to support the US economy should be positive for the dollar all else being equal. That said, we see this as truer in the case of a Trump victory than a Biden win, with a risk that the former rekindles a trade war with China and raises tariffs on European goods in a repeat of his first time in office. Similarly, Trump looks likely to

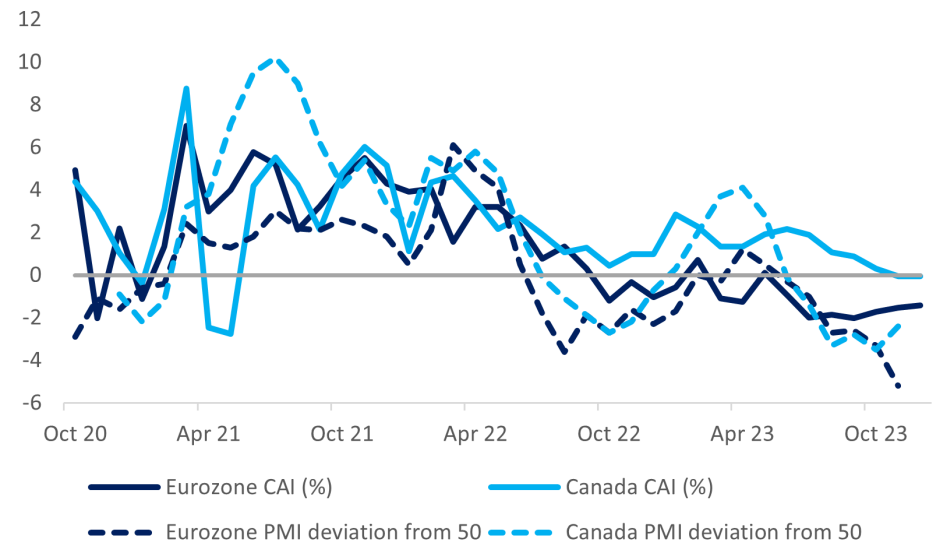
combine this with a more hawkish line on China generally, potentially escalating tensions, particularly over Taiwan, triggering a dollar haven bid. As such, though both candidates look likely to pursue policies that we see as positive for the greenback at the margin, we expect that a Trump victory would be more dollar supportive overall, making this an election for FX markets to keep a close eye on.

EUR & CAD

A Q1 reality check

Following the dovish shift in fed expectations in late-Q4, narrower rate differentials and the improved backdrop for risk saw both the euro and the loonie surge into year-end, with the former closing out the year north of 1.10 and the latter just a percent below its 2023 peak. While valuations in FX markets are justified by real rates, neither reflect the economic reality of ongoing recessions in both the euro area and Canada. As a result, December's price action scans as unsustainable, especially the late-December spike higher in CAD during a period of illiquidity. With incoming macro data likely to further reinforce our bearish views on the eurozone and Canadian economies in Q1, contrasting heavily with US data which we expect to show resilient growth conditions, we think Q1 will be characterised by a realignment in short-term interest rates with macro conditions. This should re-open front-end rate differentials, forcing EUR and CAD to better reflect their weak cyclical positions.

Both the eurozone and Canadian economies are in outright contraction by our estimates

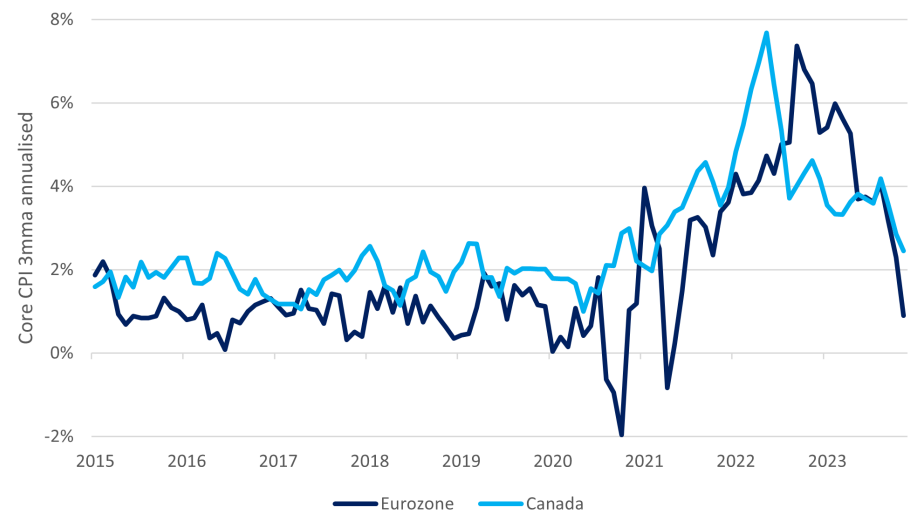


Seeing as markets entered the year roughly aligned with our views on BoC and ECB easing, a reassessment of the Fed's easing path this year will likely be the determining factor for a re-valuation in EURUSD and USDCAD. However, we note that the market implied paths for both central banks have moved in lockstep with Fed expectations over recent months. Therefore, not only will market pricing of the Fed need to adjust for both currency pairs to realign with their fundamentals, but it will also require pricing of the BoC and ECB to remain more static during this period. It is here that we are more confident given the continued weak nature of the incoming growth data and the preliminary signs that this is starting to take effect on inflation and growth conditions. In the eurozone, the underlying pace of inflation has moderated rapidly and is starting to weigh on employment conditions. While headline inflation rates are likely to remain above target due to technical factors, weakness in underlying inflation measures should lead the ECB to publicly verbalise the internal discussion on rate cuts sooner rather than later. While there is a risk that the ECB cuts the deposit rate by 25bps as soon as March given the decision is accompanied by a fresh set of staff projections, or by a larger amount if the ongoing contraction proves to be more sinister, concerns over corporate profit margins given the recent loosening in financial conditions at a time when business confidence is starting to improve will likely keep the ECB on hold until April.

“For the BoC, while its preferred measure of core inflation has also dropped off considerably having maintained a range of 3-4% for much of the past year, the pace of disinflation is markedly slower than in the eurozone.”

Furthermore, recent rounds of macro data haven't necessarily shown a consistent cooling of the economy – despite softer employment numbers, wage growth remains high, while month-on-month core inflation measures in December spiked higher. While this argues against markets maintaining a more dovish view on the BoC relative to the Fed, we think over the course of Q1 the message of weak growth will become consistent across the totality of Canadian data, forcing the BoC to cut rates in April.

Core inflation momentum in the euro area and Canada has dropped off markedly, supporting our view of earlier rate cuts in 2024



Under our base case, projected rate cuts and dovish forward guidance from the ECB as of April should see EURUSD retrace back to the Q4 low of 1.05 as early as the first quarter, assuming that US data holds up and prevent the Fed from joining suit. In the event growth data presents a more sinister recession is underway, however, we think the ECB could cut rates as early as March, with the easing cycle potentially being front loaded. By our estimates, this could see EURUSD drop back to the 1.03-1.05 range in the first half of 2024. Similarly, in Canada we expect weak growth rates to continue manifesting within inflation and labour market data throughout Q1, which should see consensus expectations firm behind an April cut. While the case in Canada isn't as clear cut as it is in Europe, owing to the elevated levels of immigration that could keep growth data more buoyant in the near-term, we think this is likely to be netted off by inventory drawdowns in late 2023 or early 2024. Weaker growth outturns and the effects of soft growth becoming visible across inflation and labour market indicators should make the case for BoC easing policy in April

more compelling, as per our base case. We expect weak growth conditions to remain a drag on EUR and CAD until late Q2, when the eventual start of the Fed's easing cycle should trigger another broad sell-off in the dollar against procyclical currencies. However, we don't expect EURUSD and USDCAD to break new ranges in this environment, as cyclical data out of both respective economies is likely to remain weak. In the second half of the year, however, the effects of looser monetary conditions should become visible on growth data, supporting capital inflows – a dynamic we see as necessary to drive a structural rally, especially in the euro. Set against a backdrop of improved global growth and looser DM financial conditions, this should support sustained gains in both procyclical currencies.

GBP

Pausing at the top of "Table Mountain"

When compared to the wild ride of 2022, last year provided a period of relative calm for the pound. Against the dollar, one-month realised volatility collapsed from the mini-budget peak to pre-pandemic average, while volatility also evaporated on the crosses, with the narrow 5% range in GBPEUR the most noteworthy. This was somewhat surprising given how bleak the consensus outlook was for the UK economy, with some even fearing Bank Rate could head north of 6%, inducing a sharp recession. However, throughout the year we had warned that markets were too pessimistic over the UK's growth prospects, favouring a stagnation in the economy as opposed to an outright recession. With this playing out, sterling posted gains of 5.4% against the dollar and 2.2% against the euro on the year.

"Having raised rates to a more moderate peak of 5.25% and avoiding an outright recession, the Bank of England now finds itself sitting pretty at the top of the "Table Mountain" path that it advocated in Q3."

Inflation is also falling at a rapid and sustained rate, while UK growth data shows the labour market remains somewhat tight amid a flatlining economy. This balance saw sterling end the year on a surprisingly good note, pouncing on the risk rally in Q4 as the Fed's "higher for longer" message began to thaw. Despite the fourth quarter surge, we think sterling is still undervalued given the backdrop of lower yet stable growth and likely higher near-term rates. While we expect an uptick in US rates and a corresponding wave of USD appreciation in the first quarter, which will naturally weigh on the pound, we expect GBP to outperform on major crosses once again. Over the medium-term, a delayed start to the BoE's easing cycle and an uptick in global growth conditions should support sustained GBP appreciation.

The UK economy should continue to outperform expectations

Turning first to growth, the 0.1% contraction in Q3 likely marks the bottom for the UK economy in our view. Notably the contraction coincided with a slump in the PMI readings to below the 50 no-change level, with these having subsequently recovered. Similarly, the latest set of retail sales figures for November delivered a significant upside surprise, growing by 1.3% MoM having delivered several consecutive weak readings. All told, whilst it likely to be close, we expect the UK economy to expand in Q4 and therefore escape an immediate recession. Further out, we are more constructive on 2024 growth. Real wage growth has now turned positive and is likely to continue rising given structural supply constraints in the labour market. Combined with typical pre-election give aways, this should better support consumer demand, the cornerstone of the UK economy.

"Our more positive view on growth is premised on a resilient labour market and weaker inflation, both of which should sustain the recovery in real household incomes."

The latest UK inflation figures showed headline price growth tracking below the BoE's November forecasts at just 3.9% YoY, and although core inflation proves stickier at 5.1%, this too is undershooting both Bank staff and market projections. From an inflation standpoint, the one remaining worry is the labour market, with wage growth remaining significantly elevated and unemployment still below the BoE's 4.5% estimate of neutral. Nevertheless, labour market pressures have begun to ease, and based on forward looking indicators, will likely continue to do so faster than the BoE expects, supporting a more benign inflation environment. What is crucial, however, is the pace at which the labour market is normalising. Recent data suggests that the labour market is cooling at a rate that should dampen inflation pressures without cause for growth concerns. If sustained, this will likely trigger the BoE to shift towards a more neutral stance in early 2023, with the MPC removing their tightening bias.

A cautious BoE is unlikely to ease as soon as or as fast markets expect

Having spent much of last year suggesting that market pricing for BoE rate rises was far too aggressive, we now think traders have similarly gotten ahead of themselves when it comes to policy easing. Markets currently expect roughly six rate cuts from the BoE next year. By contrast, we anticipate the MPC delivering just four. Considering the emphasis policymakers have placed on the feedback between rising wages and inflation, however, we think there is minimal chance that the BoE cuts rates before MPC members can see the impact of April's rise in the National Living Wage. Given that April's wage data

is only scheduled for release on June 11th, that all but rules out policy easing before the June 20th meeting in our view. Even then, whilst there is some risk of a first cut being delivered at the June meeting, we think the MPC is more likely to wait until Q3 before beginning to ease rates.

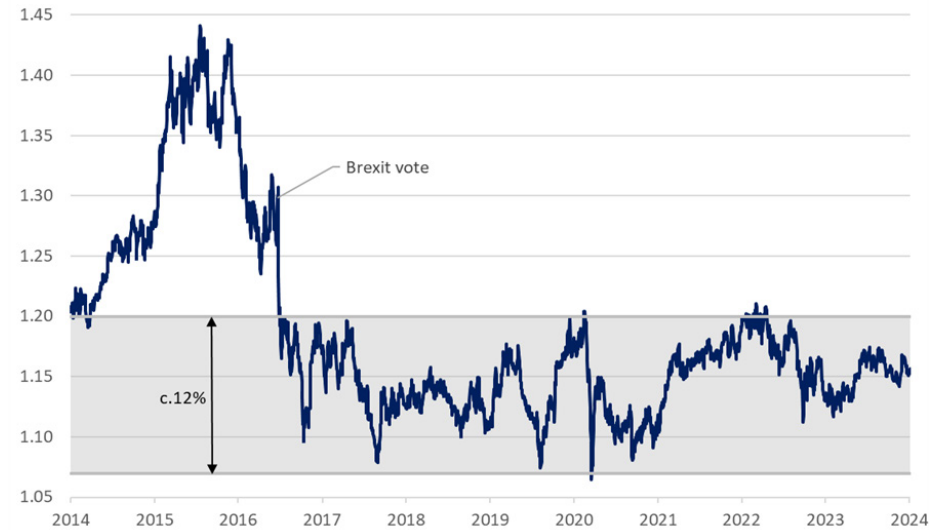
Importantly, the concern for policymakers will not be the immediate impact of any National Living Wage rise given its relatively narrow direct impact, but rather how it pushes up other wages across the pay distribution. This is likely to take several data releases to play out, making August appear a more likely meeting for a first rate cut to us. By this point, and with other peer central banks cutting by 25bp per meeting as per our base cases, the BoE should feel comfortable following suit and delivering 100bp of easing over the final four meetings of the year.

As such, with the BoE on hold and the UK economy set to exceed expectations, we look for sterling to outperform on crosses in the first half of the year. In particular, we see GBPEUR trading towards the highs of its post Brexit range over coming months, fuelled by comparatively cheap asset prices and relatively better growth, though given our forecast for continued US exceptionalism, a dollar recovery could still see cable slide modestly lower, especially in Q1. We don't however expect sterling outperformance to be sustained through H2. By this point, early cutters such as the ECB will begin to see growth improve, whilst a pivot to rate cuts from the BoE will lead interest rate spreads to narrow, especially given the BoE's higher base to cut from.

“A general election expected towards the back end of the year remains a notable risk for sterling, though with the Labour Party holding a large poll lead at present, the potential of the most market unfriendly outcome, a hung parliament, seems minimal.”

While UK markets tend to fret over less market friendly outcomes given recent history, the potential for a large majority, stable government and moderate policy could even pose upside risks to our sterling forecast in the second half of the year.

Since the Brexit vote in 2016, GBPEUR has roughly traded in a 12% range. Whilst the UK's relatively better fundamentals should support further upside in the cross, we don't expect it to break above this range in 2024

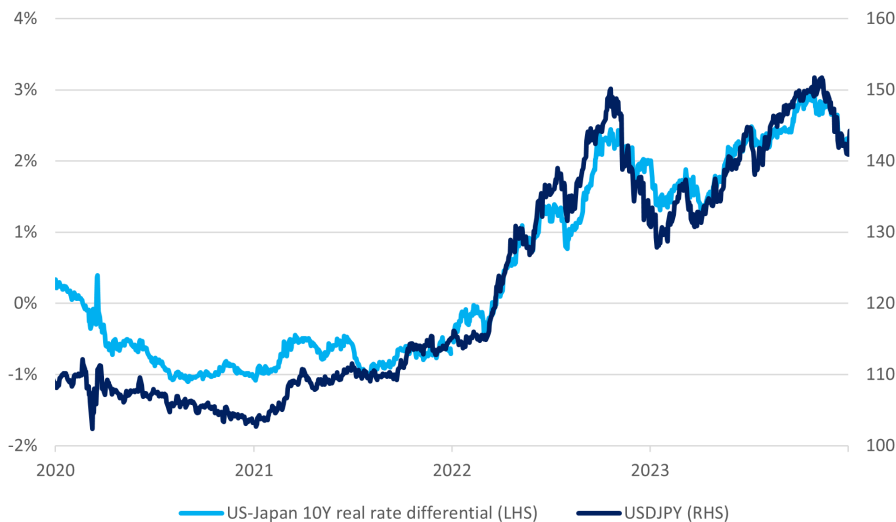


JPY

2024 to be the year

USDJPY has essentially been a play on real rate differentials since the commencement of the Fed's tightening cycle, with brief deviations in spot from the yield implied rate driven by either direct FX intervention or speculation of further policy normalisation from the Bank of Japan. As a result of continued tightening by the Federal Reserve, stronger US growth, and diverging rates of US and Japanese inflation, 10-year real interest rate differentials continued to widen for much of the past year, even as the Bank of Japan progressively loosened its grip on the 10-year JGB yield. This dynamic peaked in Q4, leading USDJPY to break above the 150 handle, leaving markets on intervention watch before weaker US growth data and continued signs of disinflation led to a rally in 10-year Treasuries and a subsequent retracement in the pair. While USDJPY dropped considerably into year-end on this dynamic, speculative short positions on the BoJ abandoning yield curve control also contributed.

Since the start of the DM tightening cycle, USDJPY has been a play on real rate differentials



Although Governor Ueda dovishly pushed back on this speculation at the December meeting by adding context to his intermeeting commentary, which was one of the origins of the hawkish speculation, and suggesting the BoJ not only needs to see wage developments but also observe their impact on inflation, we believe this suggested a longer runway to liftoff as opposed to a lower likelihood altogether. Under our base case, the BoJ will abandon its

YCC framework in April following the outcome of the Spring wage negotiations, which we expect to support tighter policy given real wage erosion in 2023, before negative interest rate policy is abandoned in October. In effect this allows the BoJ time to observe both the passthrough of the Spring wage negotiations to services inflation and bond market functionality without YCC. With US rates likely to rise amidst stronger growth and later rate cuts from the Fed, this leaves USDJPY vulnerable to an upside correction in Q1. However, over the medium-term, we expect an uptick in the JGB curve from reduced policy intervention and higher realised inflation pressures to generate a sustained rally in the yen given the currency is currently 20-30% undervalued by standard economic models. However, gains in the yen are likely to be considerably more modest than standard models suggest, with the rally likely to be diluted by the stronger equity environment amid slightly lower front-end DM rates. As a result, we forecast a near-8% rally in the yen over the upcoming twelve months.

CHF

Facing conflicting pressures

Despite its low level of carry, the Swiss franc was the fourth best performing currency against the dollar in the expanded majors last year, trailing high yielders COP, MXN and PLN. This was largely because the strength of the currency was used as an additional monetary tool, with the SNB actively favouring a strong franc for much of the year to mitigate imported inflation pressures. However, with growth stagnating, external inflation pressures cooling, and domestic deflation risks rising, the SNB removed its intervention bias in favour of a stronger franc at December's meeting. While this was suggestive that the EURCHF rate was at the bottom of the central bank's tolerance range, the signal was largely ignored by markets as EURCHF fell a further 2.5% into year-end. Although the move is somewhat attributable to the continued weakness in eurozone growth data and the franc's role as a regional safe haven, we think it materially increases the risk of recession and deflation in Switzerland.

“Should inflation data continue to undershoot the SNB's forecasts and growth data remain fragile as current momentum suggests, we expect the SNB to reinforce its dovish message to markets, sending EURCHF back to its December range of 0.94-0.95.”

While initial attempts are likely to be verbal, a lack of responsiveness in markets or continued CHF appreciation on weak eurozone growth data will merely increase the probability of direct FX intervention. As such, we no longer view short EURCHF as the best hedge for a eurozone recession and instead



prefer short EUR expressions against AUD and NZD where growth conditions are more robust and rates are likely to be held higher for longer. Over the medium-term, receding growth risks and low inflation in the eurozone will likely warrant the SNB to ease policy rates alongside the ECB, although with a lower terminal rate, SNB easing is unlikely to keep pace. As a result, SNB policy easing is likely to be focused on the level of the franc, with the SNB actively devaluing the currency to loosen monetary conditions at the margin. In combination with improving growth conditions in Europe, we expect the franc to weaken, although a break back above parity in EURCHF is unlikely as yield spreads will compress and a swathe of elections in Europe are likely to sustain some interest in defensive CHF expressions.

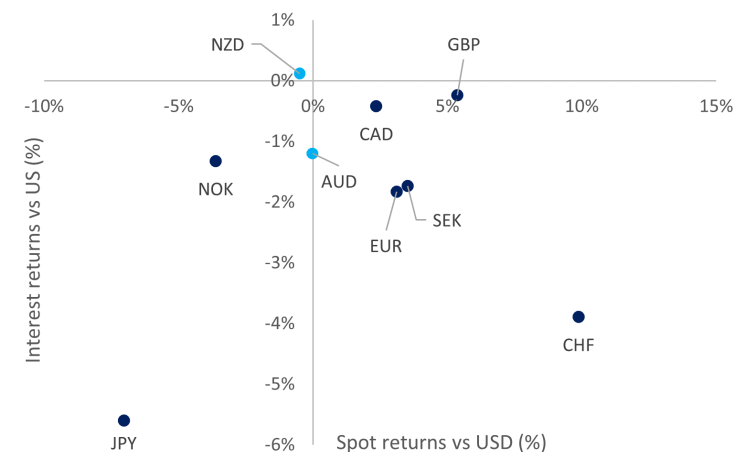
AUD & NZD

The G10 poster boys

As high beta currencies, both AUD and NZD were bogged down in 2023 by concerns over China's growth outlook, higher Treasury yields, and periods of sharp deterioration in risk sentiment. This saw both Antipodean currencies underperform their relative rate profile. With both the RBNZ and RBA set to join the cutting party late due to structural supply constraints, strong levels of growth and the market focus now set firmly on Fed easing in 24H1, we think this year will be more conducive for sustained AUD and NZD appreciation. While our base case also envisages a less benign outlook for risk assets in 2024 than implied by options markets and lingering concerns over China's growth rate as it transitions towards a more balanced economic model, we don't expect AUD and NZD to replicate 2023's underperformance relative to their yield pick-up. Firstly, we think cross-asset volatility will remain below 2023's levels, driven primarily by reduced rates vol. Second, although we expect markets to remain cautious on China's growth outlook, we think this is less likely to weigh on risk sentiment amidst an environment of falling core yields and continued policy support by Chinese officials. As such, we expect the later sequencing of RBA and RBNZ easing cycles to support structural rallies, with the impact of eventual rate cuts in 24H2 to be negated by improved cyclical optimism and broad USD depreciation. All told, we expect AUD and NZD to rank as some of the best performers against the marginally weaker dollar in 2024, with gains of around 9% respectively. While our conviction on AUD and NZD outperformance is strong, we note that downside risks remain acute from both a lagged transmission of central bank tightening efforts, which if materialized could increase global recession risks and weigh on overall risk sentiment, and from systemic financial stability issues emanating from China's shadow banking and real estate markets.

While our medium-term view on both Antipodean currencies is constructive, we don't expect the rally to commence until the Fed's easing cycle comes into reasonable scope, likely in Q2. With US data prompting a hawkish reassessment of Fed easing plans and longer-term Treasury yields in the first quarter, we expect both currencies to come under renewed pressure. Owing to the Kiwi dollar's greater sensitivity to US yield moves, higher growth rates in Australia, and the RBA's more credible hawkish bias, we expect further AUDNZD upside in this environment as rate differentials are likely to compress further.

AUD and NZD underperformed their yield pickup in 2023 as market conditions were unfavourable for China-linked high beta FX



Granted, lower commodity prices in this environment and continued weakness in China’s growth data argues against this view. However, this is likely to have a less impactful role on AUD given the transmission channel is somewhat stymied by a previous surge in tax receipts. Thus, weaker commodity prices and export volumes are unlikely to have as much of an effect on government finances in 2024, meaning any direct growth impact from softer exports is likely to be dampened by a larger fiscal impulse. Accordingly, the RBA’s hawkish bias is unlikely to be eroded under these market conditions, supporting a compressing in near-term rates in support of further AUDNZD upside.

Further compression in rate differentials in 24H1 should induce AUDNZD upside



Scandi FX

The bottom is in

The second half of 2023 saw some surprising price action across Scandi FX, with SEK rallying strongly off all-time lows against the euro, despite the Riksbank declaring an end to policy tightening, and the domestic economy falling into recession. This took NOKSEK back below parity, as the Norwegian krone was held back by sliding oil prices and foreign FX purchases. Nevertheless, the final weeks of 2023 saw this trend rebound as NOK rallied on reduced FX purchases from the Norges Bank, a hawkish hike, and a pick-up in global risk sentiment on accelerated Fed easing bets. Even after the late rally, the Norwegian krone still ranked as the second worst performer amongst G10 FX in 2023, falling by 3.6% against the dollar, a performance that placed it ahead of only the Japanese yen. The Swedish krona in contrast rose by 3.5% over the year, outperforming the euro which posted gains of 3.1%, all despite weak domestic conditions.

These moves were at odds with relative economic fundamentals in our view, which outside of oil developments had suggested sustained NOK outperformance versus SEK. With both the Norges Bank and Riksbank having now completed their hiking cycles and therefore leaving rate differentials static in the short term, we continue to favour NOK versus SEK and expect the cross to retrace through parity over coming months. More immediately, however, whilst both currencies look cheap on a fundamental basis, they also enter 2024 scanning as a little overvalued based on recent history. This is particularly true given our view that market expectations for Fed easing are far too aggressive, and that the eurozone is likely now in recession.

“We therefore anticipate both currencies weakening against the euro in the near term, as market continue to pare Fed easing bets and price in a weaker eurozone growth outlook.”

That said, we wrote last year that the end of ECB hiking would likely bring with it a top in EURSEK, though our conviction at the time was low given market willingness to chart all-time highs on the cross, and signs of ongoing weakness that continued to hamstring the Riksbank. Now, however, with EURSEK having eased off the highs, helping to soften inflation pressures in turn, we are more comfortable saying the bottom is in for the Swedish krona, meaning we only expect a modest retracement higher for EURSEK over the next month or so. The short-term outlook for NOK faces greater risks in our view. Given the apparent growing inability of OPEC+ to stabilise oil prices, we expect choppy market dynamics to continue as an idiosyncratic driver for NOK in the immediate future.

“Looking further out, domestic inflation pressures are cooling in both Norway and Sweden, meaning that for both the Riksbank and the Norges Bank, the next policy move looks more likely to be a rate cut than a hike, though there remains a small risk of a final rate rise in Q1 from the Riksbank, especially following its failure to deliver one in November.”

That said, currency strength is set to be a key consideration for both Scandinavian central banks once again in 2024 given the impact it has had on imported inflation pressures across the region. Based on our short term forecast for Scandi FX weakness, we think risks of renewed currency depreciation will likely preclude rate cuts by either central bank before Q3.

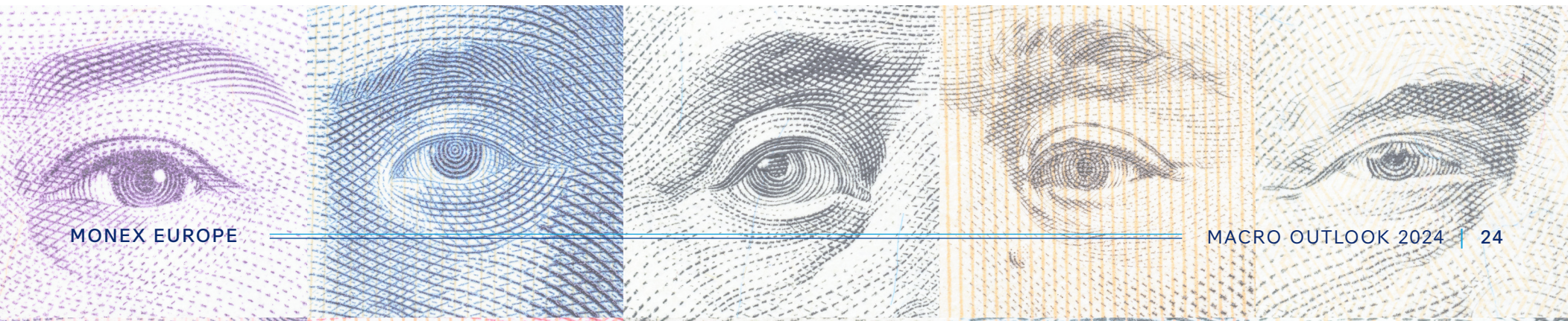
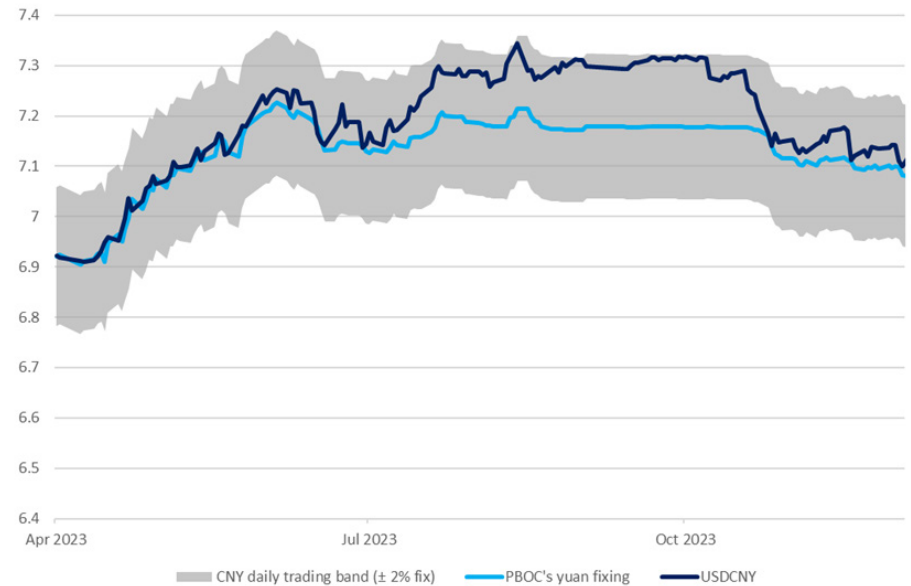
Given the emphasis on the strength of their respective currencies, we do not envisage either central bank cutting rates before the ECB. This means that a combination of better external growth, more attractive rate differentials and cheap valuations based on fundamentals should prove supportive of Scandi FX as we move deeper into the year. However, there is a risk that markets attempt to front run this move, keeping both NOK and SEK stronger than we expect under our base case. If this were to happen, it would potentially open the door to a Q2 rate cut, particularly in Sweden where domestic conditions remain weak. It is notable that the Riksbank has now moved towards holding eight policy meetings a year, allowing for the flexibility of a Q2 rate cut, and where policy stimulus would be desirable to support the economy. This would not affect our longer-term forecasts for both NOK and SEK appreciation over the next twelve months but could mean that these moves play out a little earlier than we currently envisage.

CNY

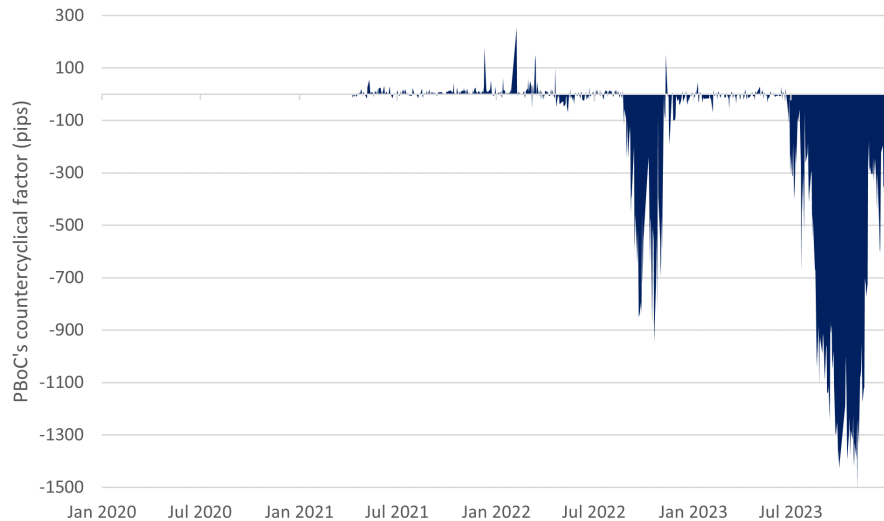
Micromanaging the transition

After the sudden end of its zero-Covid policy, optimism over China's economic recovery led USDCNY to drop to a low of 6.7, from which point underwhelming growth data and higher Treasury yields prompted a retracement back above 7.00. With growth still sputtering, the People's Bank of China had to buck the trend and cut policy rates to incentivise growth at a time when the higher for longer narrative in the US was taking hold in markets. This saw USDCNY rise to 7.30, a level that ultimately proved sensitive to the central bank, who stepped in to micromanage the currency market as further currency depreciation was seen undermining consumer confidence and thus the impact of policy easing on growth. For around three months, the PBoC's actions effectively introduced a soft currency peg to markets, which eventually broke to the downside as US rates dropped off and a recovery in the yuan was supported by intervention through state banks. While the move lower in USDCNY was sustained into year-end, it wasn't without the central bank's support as the daily fixing rate was held at 7.1.

After promoting downside in USDCNY, the PBoC's fixing essentially flatlined in late Q4 to maintain USDCNY at 7.15 even as market forces suggested otherwise



This maintained the countercyclical factor, a regime we expect to be maintained into 2024



Given our expectation of an uptick in US rates, fears over China's shadow banking and real estate markets, and lingering concerns over China's ability to produce elevated growth in the absence of policy support throughout this transitional period, we think upside pressure on USDCNY is likely to be sustained throughout the first quarter, leaving USDCNY to hover around 7.15 by our estimates. Market forces favour upside in the pair, especially given lacklustre levels of FDI and portfolio outflows, the PBoC's preference to prevent CNY depreciation and their effectiveness to do so is likely to put a low ceiling on the currency pair from current spot levels. As such, risks to our view largely tilt to the downside.

“While there is a chance US rates could cool further, lifting sentiment on low yielding Asian FX, we don't see this as likely in a risk supportive aspect.”

Instead, risks of further CNY appreciation emanate from further policy support, which if unveiled should improve cyclical sentiment on China. Over the medium-term, we expect lower US rates, improved global growth conditions, and a stabilisation in Chinese activity indicators to support renewed capital inflows into China, taking USDCNY back below the 7.00 handle by year-end.

INR

Steady is the hand

Rising oil prices and an aggressive hiking cycle from the Fed last year raised concerns that India was set to experience another 2013 “taper tantrum” style sell-off, which saw the rupee gap 20% lower between May and September, sparking inflation and concerns over financial stability. However, this time proved different. Not only did the RBI mobilise its much larger FX war chest, it also embarked on numerous alternative measures to support capital inflows such as relaxing external borrowing limits.

“With the rupee in much better balance with India's economic fundamentals, these measures proved sufficient in not only stemming the slide in the rupee, but also stamping out overall volatility.”

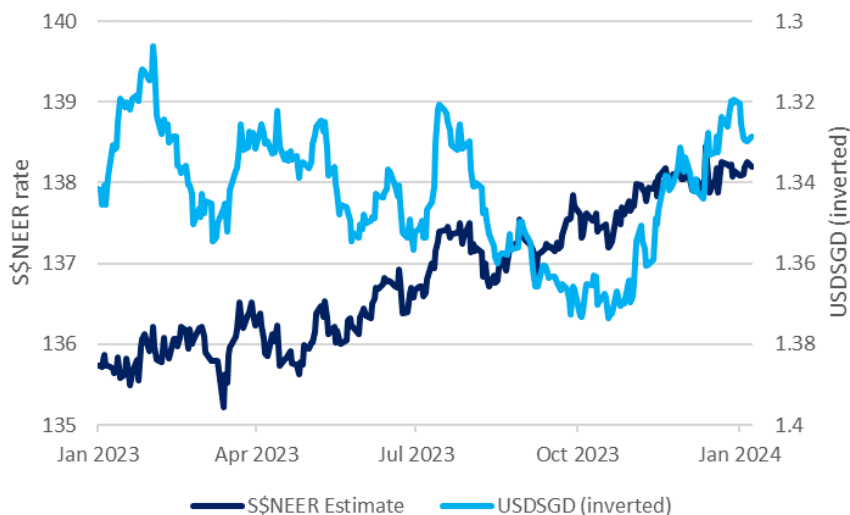
This regime persisted throughout 2023, leading INR to outperform EM peers during periods of significant USD appreciation, albeit at the cost of underperforming in risk rallies. We expect this pattern to continue into 2024 as there are no signs of the RBI relaxing its control on the currency, limiting depreciation throughout Q1 through direct intervention and liquidity management when we expect the dollar and yields to rebound, and accumulating FX reserves for the remainder of the year to stymie INR appreciation on a broadly weaker dollar and supportive fundamentals. Like many peers, India is also set to return to the polls this year. Early indicators suggest the question isn't who will threaten Prime Minister Modi's third term, however, but rather who can reduce his governing majority. At present, the threat of a coalition looks minimal, with the newly formed alliance coalition INDIA yet to unite on critical issues, meaning a market friendly continuation in governance is likely to occur, keeping India's structural reforms on track. While this should support further INR appreciation, we expect it to be dampened by the RBI.

SGD

Steady appreciation, but not immediately against the dollar

Having tightened policy significantly in 2022, the Monetary Authority of Singapore kept its policy settings on hold over the past year. In conjunction with slowing global growth, rising geopolitical tensions and a downturn in the goods-cycle, growth in the Singapore economy slowed markedly from 3.7% in 2022 to below 1% in 2023. Slow growth and tighter monetary policy saw core inflation cool significantly, falling back to the MAS inflation forecast band of 3.5-4.5%, with the latest November data falling further to 3.2% YoY. Strong disinflation was also visible in the headline measure, which fell back to the MAS forecast band of 3-4%, printing at 3.6% in November. While we expect growth conditions to improve as the global goods cycle recovers and inflation cools, we don't expect this to have a material impact on inflation, which we believe will continue to moderate in 2024 as per the MAS forecasts.

The S\$NEER rate has been steadily appreciating throughout 2023, but gains haven't been consistent against the greenback



Nevertheless, risks of resurgent inflation, most likely through tighter global commodity markets, will likely keep the MAS retain a hawkish stance. We expect the central bank to maintain its current gradual appreciation preference in the trade-weighted Singapore dollar. This will likely see the S\$NEER rate appreciate a further 1.6% over the course of next year, with gains most visible against low yielding Asian currencies throughout the early part of 2024 amidst an uptick in US rates and a backdrop of a stronger US dollar, before rallying on an improved cyclical backdrop in 24H2, offset partially by losses against

regional peers. Risks to our view largely stem from the increased number of policy decisions from the MAS next year as it moves from semi-annual decisions to quarterly. Faster disinflation and weaker growth conditions could lead the MAS to flatten the S\$NEER trajectory, limiting USDSDG downside into year-end, while an uptick in inflation pressures will likely be met by swifter policy action given the central bank's ability to now fine tune its approach.

TRY

Slowing the sell-off

Last year saw the lira fall close to 40% against the dollar, as political risks, inflation, and a pivot in economic policy all combine to pummel the Turkish currency. Significantly though, President Erdogan's election victory last summer was followed by an about turn on using interest rates to tame inflation that should prove more supportive for the lira over the medium-term. While a policy reversal remains a considerable risk, the current macroeconomic framework looks to be paying dividends and should lead to more moderate TRY depreciation throughout 2024.

Indeed, we expect monetary policy to be the key to how the lira trades over the coming year. Whilst the initial result of policy normalisation last year was a spike in price growth that left inflation running at 65.0% YoY in December and produced a sharp TRY sell-off, efforts by the CBRT are now starting to bear fruit. Having raised the one-week repo rate from 8.5% to the current 42.5% level since taking over, monthly inflation is down to 2.9%. Furthermore, after seeing the monthly run rate spike to 9.5% over the summer, MoM figures have now printed below 3.5% for three months in a row. Further progress on cooling inflation will require monetary policy to remain tight for some time. But with Erkan now having established credibility with markets, USDTRY's ascent has slowed markedly.

"Indications from the CBRT's December policy meeting suggest that more tightening is set to be delivered."

In the context of other recent communications, we suspect this means a final hike is likely in January, anticipating a 250bp rise in the one-week repo rate to a peak of 45.00%. While in the context of inflation above 60% this may not seem restrictive, with current inflation momentum annualising at 39%, we believe the CBRT will take some comfort in completing its tightening cycle, if only temporarily. If delivered, disinflation should start to pick up pace as we head through 2024. In our view this opens the door to modest policy easing in the second half of the year, though the CBRT will likely want to see real rates turning positive and the lira stabilise before committing to rate cuts. As such

we think USDTRY will continue to rise through the early part of 2024, though at a far slower pace than seen last year. The second half of the year, however, is likely to see a recovery in TRY, with high nominal rates and positive real rates set to offer attractive carry returns. That said, caution must be paid to the March local elections, which could produce a further shift in Erdogan's newfound commitment to orthodox monetary policy. Given this, risks to our outlook remain tilted towards renewed lira weakness in the event policymakers once again drift from conventional monetary policy.

ZAR

Set to go from zero to hero

The latter part of 2023 found the rand caught between two key dynamics, resulting in it largely trading water, underperforming most other high yielding EM currencies. The first of these was a continued sell-off in Treasury yields, boosting global risk conditions and driving the dollar lower. Weighing against this, however, was a Chinese economy that continued to underwhelm, which together with crumbling infrastructure locally meant that soft South African exports continued to be a drag on the value of the rand. Domestically, energy supply concerns continued to weigh on the economy in 2023 too, though with Eskom bringing the Kusile Power Station back online, these worries have now begun to ease. This, combined with a hawkish SARB that looks set to keep rates at 8.25% well into 2024, falling inflation, a narrowing current account deficit, and cheap asset prices, an inflection point in USDZAR is near, one that in our view should see the pair retrace 2023's losses through the year.

A reversal of late 2023 dynamics looks set to play out over the first few months of 2024, which in our view should see the USDZAR remain rangebound initially. Markets have been too aggressive pricing Fed easing expectations in our view, and we expect to see these unwind in the first few months of the year. This is likely to be counterbalanced by stability in CNY and continued mixed signals on Chinese growth, which shouldn't prompt another significant bout of ZAR weakness but won't necessarily inspire optimism either. Beyond this point, improving domestic fundamentals, looser monetary policy across developed markets – particularly as the Fed begins to ease – and a continued pick up in global growth conditions provides a much more positive backdrop for the rand to trade in. Indeed, given the likelihood of the SARB staying on hold though much of the year, a combination of ZAR's high cyclical beta and an improving real rates profile relative to peer currencies should see ZAR perform rank amongst the best performers across EM FX in 2024.

That said, whilst we see the broad macro backdrop as positive for the rand, an uptick in cross-asset volatility holds the potential to slow the pace of appreciation, given this would imply an increased risk premia on South African assets. Whilst this should not preclude rand appreciation given that it should be accompanied by falling yields, particularly on Treasuries, it may see the rand underperform relative to the move implied by yields alone. The single biggest risk to our outlook for ZAR is an upcoming general election, which we expect to take place in Q3. The ANC is once again expected to pick up a plurality of votes, but the key for markets will be whether they gain enough support to govern outright. If the ANC does secure a majority, the rand may see some modest support on a continuation of the status quo. If they fail to do so, however, then the EFF could enter government as a coalition partner, posing a major downside risk to our forecasts. Given the EFF's commitment to expropriation and having seen the impact this had previously on neighbouring Zimbabwe, investors would likely shun South African assets, risking a sharp ZAR sell-off.

CE3 FX

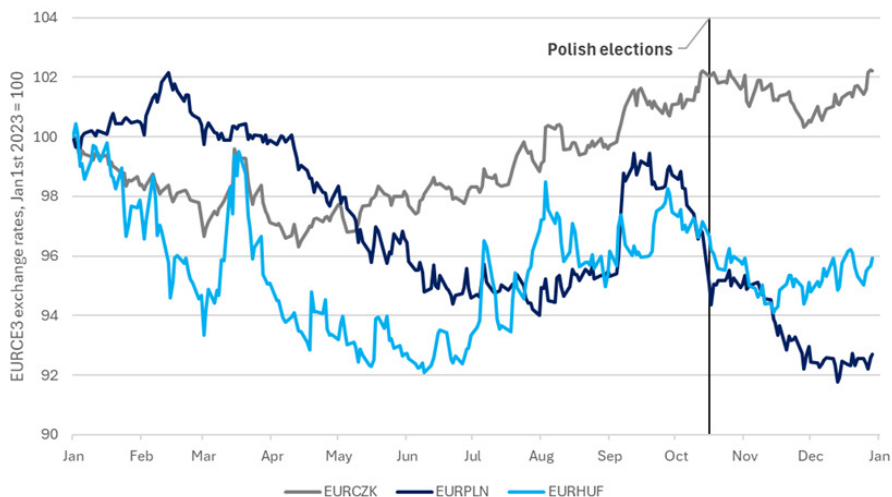
More vulnerable without carry support

With carry king for much of the last twelve months, it is perhaps not a surprise to see CE3 FX amongst the big winners of 2023. All three currencies finished the year in the green against the dollar, though in the case of the Czech koruna, this was by a narrow 0.9% margin. The zloty and the forint by comparison recorded impressive 11.2% and 7.5% gains against the greenback respectively.

“On face value the outlook for early 2024 looks bleak for CE3 currencies.”

On face value the outlook for early 2024 looks bleak for CE3 currencies. With the eurozone economy falling into recession, external demand is set to weaken which should weigh on peripheral European FX. Domestically, we expect policy rates to continue falling across the bloc, supporting growth in the face of external headwinds, but weighing on the attractive rates profile that has proven such a boon for CE3 FX. This is particularly true in Hungary, which having raised rates the most, now has furthest to cut, suggesting any rate induced downside should be relatively more pronounced for the forint.

Polish elections in Q4 raised hopes that EU funds would be unlocked for both Poland and Hungary reducing regional risk premia. This saw both the PLN and HUF outperform into year-end versus CZK, which should continue in 2024



Politics too is also set to be a major factor once again in 2024 and is key to unlocking EU recovery funds for both Poland and Hungary. In the former case, Donald Tusk's election victory in Q4 last year should eventually do just this, albeit political hurdles continue to slow the process. Hungary, by contrast has already managed to unlock some of their funds that were previously withheld. Moreover, with PiS out of power in Poland, it seems Orban's government has no allies left to block EU sanctions and will likely now offer the EU sufficient cooperation to unlock the rest. All told, these inflows should to some degree compensate for weak eurozone growth, helping both the zloty to hold its ground against the euro and moderating an expected forint sell off in the first half of the year. With the Czech Republic not benefitting from EU funds to the same degree, the koruna should weaken in early 2024, though a modest pace of monetary easing should keep any sell-off contained.

Monetary easing across the bloc is likely to have either already concluded or be well within sight by year-end. With the ECB set to deliver cuts into 2025 under our base case, the prospect of rate differentials re-widening heading into year-end should support some upside for CE3 FX over the longer term. Better growth prospects in the second half of 2024 should also help too, boosted not only by the lagged effects of domestic policy easing, but also a pickup in external demand as ECB rate cuts similarly work to support the eurozone economy. As such, despite looking for broad based weakness in the first half of 2024, we expect the second part of the year see CE3 FX staging a recovery.

LatAm FX

Another year of strength ahead

2023 will be a year remembered for many things, but for currency markets it will primarily be recognised as the golden year of the carry trade. Exposure to high yielding currencies generated total returns of around 28%, while the level of carry accounted for a near two-decade level of differentiation in EM performance at 80%. The dominance of the carry trade was consistent with the overall macroeconomic conditions of lower cross-asset volatility, reduced DM recession risk, and the end to the Fed's tightening cycle. But it wasn't all about interest rate pick-up specifically as most of the high yielding basket also witnessed an improvement in cyclical and structural conditions, especially those that outperformed within Latin America.

High carry and improving fundamentals have led some within the LatAm complex to post significant gains against the dollar



Across Latin American currencies, the level of carry has been one of the major differentiating variables. For the Peruvian sol and the Chilean peso, lower terminal rates and earlier monetary easing proved to be particularly punitive, especially as the decision to ease rates coincided with the sell-off in DM duration in Q3 that proved particularly painful for the popular carry trades. While the BCB and the Banco de la República of Colombia also cut policy rates last year, the erosion in carry provided less of a headwind as it commenced from a higher base and coincided with a drop in DM rates and domestic inflation. Banxico remains the anomaly within Latin America as it continued to hold the policy rate at 11.25%. This relatively hawkish stance

provided MXN with stable gains throughout the past year, even as valuations in the peso were less attractive.

Fundamentals also played a role. In Mexico, for much of 2023, the resilience of the economy has reflected the solid state of both domestic demand, supported by the strong pace of real wage income growth and substantial government spending, and external demand, driven by the strength of the US economy, the effects of nearshoring and the recovery of global supply chains. Brazil's fundamentals also improved throughout the year with higher-than-expected growth in 2023. Domestic growth was supported by continued disinflation, which supported real income growth and opened the space for long-awaited monetary easing, while more supportive global market conditions, especially in China, also benefitted Brazil's external position.

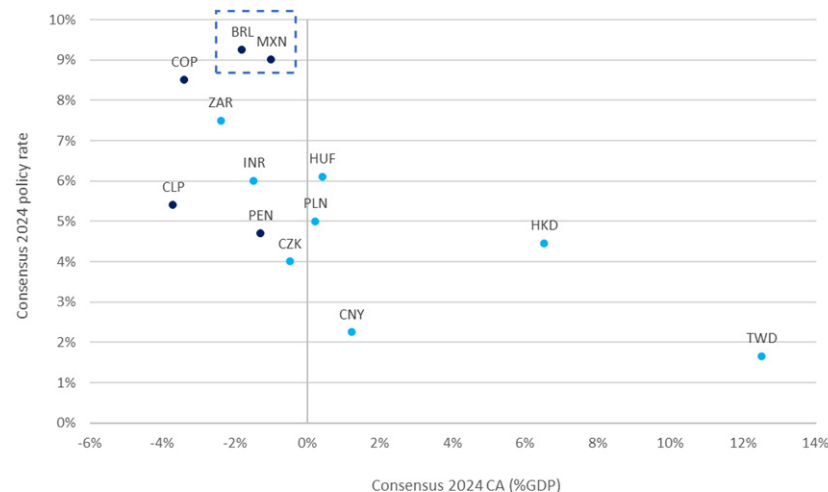
“While political developments hampered both MXN and BRL throughout the year, it was a more restrictive factor for the Brazilian real, especially in the first half of the year.”

Issues such as delays in the approval of the fiscal plan for 2023, or the debate during the first half of the year between Copom and the central government on the need for a looser monetary policy, have challenged the foundations of the Brazilian economy and, with it, the strength of the real. In Colombia, the peso's extraordinary rise in the second half of the year, but especially in Q4, was also due to a combination of factors in which economic fundamentals played a key role. In general, the effective control of inflation and the determination of BanRep of Colombia accounted for much of the attractiveness of its currency, not to mention the progress in closing the current account deficit to 1.7% of GDP in Q3 and strong job growth. However, not all experiences in the region have had such a positive outcome in 2023. In Chile, despite the launch of the regular US\$ 40 million per day dollar purchase programme by the BanRep of Chile from June onwards, or the rise in copper prices from October onwards, the Chilean peso has not been able to follow a similar trajectory to its partners in the region. Behind this disappointing result lies flat growth in 2023 and expectations of only a marginal acceleration in 2024 according to the forecasts of the national monetary authority. Finally, in Peru, the continuous contraction of growth throughout the year has placed the economy in a technical recession since 23Q2. This, together with the high political instability derived from the continuous changes of government that have caused the country to have had four presidents in the last four years and a failed attempt of a “self-coup” of State, has left many investors highly sceptical of the sol.

As carry fades away, we are back to fundamentals.

In 2024, the attractiveness of carry is expected to be significantly lower, with yield dispersion declining and probably bottoming out by the end of the year. In addition, we believe the macroeconomic backdrop and current valuations will remain more challenging, with some of the trends and debates that emerged in the second half of 2023 set to dominate in 2024. Perhaps the most important for Latin American currencies is the growth prospects in the US and China, both of which are subject to a high degree of uncertainty. Furthermore, local politics is going to become a more pressing matter for LatAm markets with elections in Mexico and the end of the BCB's easing cycle potentially sparking another round of tensions between the central bank and the Lula administration, especially as BCB President Campos Neto's tenure comes to an end. All told, this should make next year more challenging relative to 2023's long LatAm receivers trade.

Despite central bank easing, still high policy rates and strong economic prospects (measured through current account deficits) should see BRL and MXN remain some of the top EM picks



Nevertheless, while we do not expect LatAm currencies to replicate 2023's sizable gains, we don't think the ongoing easing cycles will lead to significant depreciation. Additionally, with DM policy rates set to fall this year too, we think there is still a case for carry trades, with more moderate total returns largely driven by interest pick-up. Our continued bullish outlook on both MXN and BRL is not solely motivated by our view that policy rates will remain relatively

elevated, but also our view that resilient economic conditions are likely to sustain investor appetite in the region. In Mexico, we expect the strength of the Mexican economy to extend through the first two quarters of the year, with growth expected to exceed 2.7%. This, along with near-shoring investment, should support continued capital inflows into the Mexican economy. However, we believe that the second half will bring significant challenges that threaten the so far unblemished health of the Mexican economy. The post-election hangover, which will bring with it a possible readjustment of public spending, coupled with a potential slowdown of the US economy, are likely to take their toll on domestic growth. In Brazil, both domestic and external sources of growth are likely to remain robust. The trade balance as a percentage of GDP is expected to be close to two-decade highs, thanks in part to the expected continuation of fruitful trade relations with China, while the recent tax reforms should materially boost inward investment. On the domestic side, looser monetary conditions and sustained lower inflation rates should continue to support growth.

Mexican election: continuity the most likely option

One of the risk factors for Mexico's economic stability and the peso's continued strength is this year's elections. Even in the pre-campaign period, the polls and surveys known so far point to a virtually undisputed continuation of Andrés Manuel López Obrador's legacy for the next six years. On the verge of ending his term in office with one of the highest approval ratings in recent years, AMLO has chosen who will replace him as head of the Morena party to run for the presidency in the next term. Claudia Sheinbaum, former mayor of Mexico City and a close ally of the president, appears to enjoy the acceptance needed to perpetuate her predecessor's mandate, placing her ahead of the Opposition Front's equally beloved candidate, Xóchitl Gálvez, in all polls. In what is likely to remain a two-candidate race for the presidency, sentiment appear to be fairly clear, painting a much less uncertain political picture than six years ago. However, the stakes in either scenario are far from zero. Similar to what her predecessor did, there is a fear that Sheinbaum's campaign will be mired in various controversial statements, although in view of the current legislature which has generally been far from controversial, these will probably be limited to appeals to a part of the electorate more averse to the usual policy proposals.

“In any case, and until the elections are held on 2 June, the Mexican election campaign should not be an extremely decisive factor for the peso.”

In the aftermath, one of the great challenges for the next administration will undoubtedly be to reduce the primary deficit, projected to be 1.2% of GDP by 2024, a multi-year high, amid commitments on social spending, pensions and debt servicing. Key to this will be not only the presidential election, but also the composition of Congress, given that any fiscal reform proposal will require a qualified majority in the lower house. Inability to drive reforms by a gridlocked Congress will likely sour sentiment within Mexico's bond market, a dynamic that could cause MXN to significantly unwind from its strong valuations.



Monex's January 2024 Forecasts

Currency Pair	1-month (31 st January 2024)	3-month (31 st March 2024)	6-month (30 th June 2024)	12-month (31 st December 2024)
G10				
EUR/USD	1.07	1.05	1.10	1.14
USD/JPY	145	145	138	130
GBP/USD	1.26	1.25	1.28	1.32
USD/CHF	0.88	0.90	0.89	0.86
USD/CAD	1.36	1.38	1.36	1.32
AUD/USD	0.67	0.66	0.70	0.74
NZD/USD	0.61	0.61	0.65	0.69
USD/SEK	10.7	10.9	10.2	9.5
USD/NOK	10.65	10.67	9.73	9.30
DXY	104.42	105.98	101.70	97.77
Emerging Markets				
USD/CNY	7.15	7.15	7.0	6.8
USD/INR	83	83	82	80
USD/SGD	1.34	1.34	1.30	1.28
USD/ZAR	19.0	19.0	17.5	17.0
USD/TRY	30	31	33	28
USD/PLN	4.11	4.19	3.91	3.68
USD/HUF	364	381	345	316
USD/CZK	231	23.6	22.9	21.6
USD/BRL	4.9	4.9	5.0	5.2
USD/MXN	17.2	17.2	17.1	17.0
Euro Crosses				
EUR/GBP	0.85	0.84	0.86	0.86
GBP/EUR	1.17	1.19	1.16	1.16
EUR/CHF	0.94	0.945	0.98	0.98
EUR/CAD	1.46	1.45	1.50	1.50
EUR/SEK	11.4	11.4	11.2	10.8
EUR/NOK	11.4	11.2	10.7	10.6
EUR/TRY	32.1	32.6	36.3	31.9
EUR/PLN	4.4	4.4	4.3	4.2
EUR/HUF	390	400	380	360
EUR/CZK	24.75	24.80	25.20	24.60
EUR/BRL	5.24	5.15	5.50	5.93
EUR/MXN	18.4	18.1	18.8	19.4

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