MONEX

FX Forecasts

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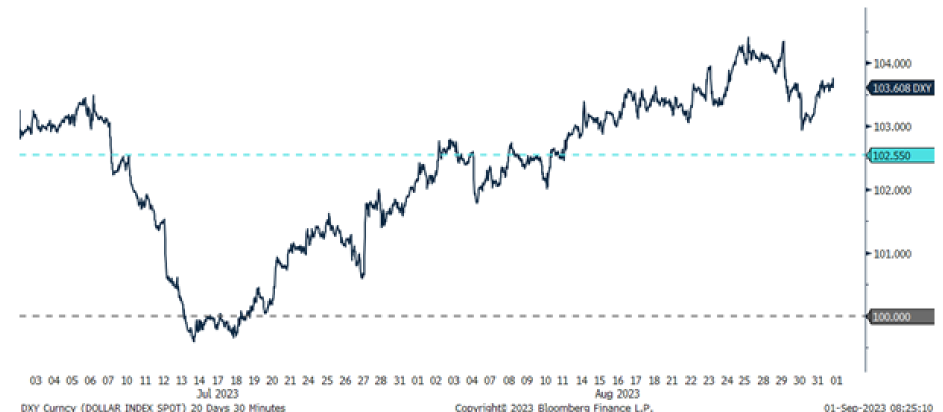
INTRODUCTION

Focus on quality

August's forecast document was titled "the defiant dollar" on our view that US exceptionalism and the residual risk of a Q4 rate hike from the Fed would prevent the dollar DXY index from structurally breaking below the 100 level in the near-term, even after a brief test of the 15-month low in the middle of July following constructive labour market and inflation data. In fact, we didn't expect the broad dollar index to fall back into double digits until early 2024, at which point we expected the prospect of Fed easing to come back into view for markets and the advanced progress on the inflation battle in the US to result in the Fed leading the return in DM real rates to more neutral levels. While events in August did generally meet our expectations, the downturn in growth conditions outside of the US was more accentuated than we had anticipated. This dented the brief rebound in cyclical optimism, leading the dollar to find a slight haven bid and the DXY index to outperform our mildly bullish one-month forecast of 102.55.

The DXY index marginally overshot our one-month forecast as deteriorating global growth conditions spurred a haven bid



Specifically, data out of China undershot our expectations and highlighted that previous actions by Chinese officials to incentivise the local consumer had yet to take significant effect. The weak growth data were compounded by the PBoC's decision to cut short-term lending rates for the second time in three months and further loosen macroprudential measures for investors. In combination with harrowing headlines around China's property market and its shadow banking sector, news out of China was generally gloomy in August and led the market risk environment to deteriorate considerably. China wasn't the only economy where the storm clouds accumulated more aggressively than we had expected. In the eurozone, flash Q2 GDP readings in Italy and Germany came in weak, while strength in the French number was dubious due to volatile trade components. Accounting for this and the notoriously misrepresentative Irish GDP data, eurozone growth was relatively flat in the second quarter with a reading of 0.15% QoQ by our estimates, and PMI data for mid-Q3 suggested the slowdown only persisted with Germany likely heading into recession. This contrasted heavily with the US, where advanced Q2 GDP landed above economist expectations and the Fed's forecast for potential at the end of July, with the bulk of the upside surprise driven by the durability of the consumer. Data released in August suggested the US consumer remained in good shape in the first two months of Q3, and even though the second reading of Q2 GDP saw the growth rate get downgraded, estimates of personal consumption were revised up further. Taken together, growth data over the past month reinforced the US exceptionalism narrative, weighed on global equities, albeit to a lesser extent US equities, and led the dollar higher.

It wasn't solely growth differentials that produced the negative correlation between the greenback and global equities, but also developments in the US Treasury market, where the focus soon migrated from the front-end of the curve to longer-term rates. The sell-off in duration initially began on concerns over the US fiscal trajectory after Fitch downgraded the US sovereign rating from AAA to AA+, but with growth conditions in the States holding up under a higher Fed funds rate, a steepening in the US Treasury curve persisted as the discourse turned to a higher neutral level of interest (r*) in the US. While the rally in back-end Treasury yields was subject to corrections throughout the month, namely on an underwhelming Powell speech at Jackson Hole and signs that the US labour market was cooling, the steepening of the yield curve kept pressure on cross-asset risk appetite and supported the greenback.

"Looking ahead, the key consideration for markets will be the magnitude of the eurozone slowdown, the likelihood of more tangible stimulus from Chinese officials, and whether further signs of a soft landing in the US will ultimately boost global risk appetite or keep investors in a more selective mindset outside of the dollar."

On eurozone growth, recent inflation and wage data out of the continent suggests that a further rate hike is more likely than not in September, even as growth conditions scan as weak. Similar to New Zealand and Sweden, it now looks like the ECB may have to induce a recession in order to weigh on core price pressures. Meanwhile, in China, officials continue to show a preference to tweak a multitude of peripheral measures in order to quell the growth slowdown and maintain their longer term economic goals. As a result, we expect further monetary easing to take place over the coming months alongside a continued easing of macroprudential measures. Should activity data suggest that 5% growth this year remains unattainable heading into mid-Q4, we expect more tangible fiscal stimulus measures to be announced, as missing the "achievable" growth target would warrant a regime change in China's political economy. However, we note that this is a risk to our base case where the growth slowdown is instead managed through credit and regulatory channels. As a result, we don't expect sentiment around global growth ex US to improve in the near-term. In this environment, we expect data suggestive of a soft landing in the US to weigh on Treasury yields but not necessarily the dollar, at least not durably. Reflecting this, we have pushed back our call for a structural dollar decline and don't expect the DXY index to fall below the 100 handle within the next 6 months. Instead, we continue to favour the greenback against yield (JPY) and growth sensitive (EUR and CNY) currencies, while we continue to believe currencies with strong fundamentals will outperform.

The DM hiking cycle still has some juice left despite the Fed hitting terminal

While data out of the US suggests that the Fed has hit its terminal rate of 5.25-5.5%, inflation conditions in most other DM economies point towards further tightening. Only in New Zealand, and to a lesser extent Switzerland, do we believe the hiking cycle has definitely halted. After increasing the overnight cash rate by 525bps, the RBNZ has now induced a recession that is weighing on inflation dynamics, whereas in Switzerland the SNB now finds itself with both headline and core inflation below its less than 2% ceiling. In Canada and the eurozone, progress on disinflation has generally stalled. We now expect this to lead to a further rate hike from the ECB, while recent inflation data poses credible upside risks to our 5% terminal rate call in Canada. Furthermore, despite progress being made on the headline inflation measures in Australia, the UK and Scandinavia, underlying price measures still remain concerning and should see further hikes in September. In Australia, 3-month annualised growth of CPI ex volatile items and holiday travel continues to track at 5.1%, while in the UK progress remains absent on services inflation. In Scandinavia, the sequential pace of inflation remains uncomfortably high, even as year-on-year measures are starting to fall from their peaks. Out of all DM economies, however, the case for more durable monetary tightening is most compelling in Japan, largely due to their limited actions to date. Despite a building cause for further tightening in the inbound data, we think the BoJ is unlikely to break from its position as the most conservative hiker in the DM space, however, we can't rule out the risk of further normalisation in the next few quarters as any decision to abandon yield curve control won't be signalled in advanced for obvious reasons.

New Zealand

Job done

Outside of the US, New Zealand is the only economy where we believe the hiking cycle is now complete. Since October 2021, the RBNZ has increased the Overnight Cash Rate by 525bps, which has tipped the economy into a necessary recession to bring inflation back to target. While the rate of non-tradable inflation remains elevated, slowing growth and increased capacity due to immigration inflows are set to return inflation back to the target range by 2025. Furthermore, a contraction in the housing market has been welcomed by the RBNZ, with the decline likely to have now bottomed out given the continued supply constraints. Overall, the progression of economic data saw the central bank strike a fairly confident message in their August meeting that the hiking cycle is likely complete with rates likely to be held at current levels well into 2024, although near-term risks are tilted to the upside. In our

assessment, the RBNZ's hawkish bias is aimed at keeping wholesale financing conditions relatively tight, the same motivation for their surprise 50bp hike back in April, and the risk of further tightening in New Zealand is a lot lower than their communications suggest. In our view, the risk of a subsequent hike in New Zealand are the lowest in the DM space.

Switzerland

A sizable tail risk of another hike

Swiss inflation data released at the start of September is likely to hold the key for this month's SNB policy decision, and by extension the outlook for the Swiss economy. When the SNB last hiked rates in June, they projected that YoY inflation would lie at 1.7% by the end of Q3. Since then though, CPI readings have undershot expectations, with markets anticipating that this latest release prints at 1.5%. Granted, the logic underpinning an SNB hike this month was expectations for a resurgence in inflation towards the back end of the year that would take the CPI reading above the SNB's 2% upper tolerance band. But given the underperformance in price growth YTD, this looks increasingly improbable to us. Doubly so once taking account of a worse-than-expected slowdown in growth conditions both domestically and in Europe, combined with CHF strength that has weighed significantly on imported inflation.

> "Crucially though, wage growth looks set to fall back to around 2% this year, consistent with the SNBs target, suggesting domestic price pressures should be less of a concern despite previous SNB jawboning on this point."

Even after accounting for all of this, we wouldn't be surprised if the SNB hikes given their historically hawkish attitude towards inflation. But with risks now tilting towards a further hike looking like an overtightening, we think the data just about tips the balance to holding rates at 1.75% instead.

Canada

Any resumption is likely to occur in October

All has been quiet on the Bank of Canada front over the past month. The last time markets heard from the BoC, officials had raised the policy rate by 25bps to 5%, the second hike in a row after a four-month pause. July's hike, which was accompanied by hawkish commentary, briefly drove speculation that a third post-pause hike would be delivered in September. Our view, however, has always been that the Bank of Canada was merely trying to justify their initial decision to abandon the pause back in June, and that nothing indicated a continued desire to hike a third time. Markets have come around to our view, with OIS pricing now pointing to a 20% chance of a September hike after peaking at 40% a month ago. The handful of data points released over the course of August broadly reinforced our base case, with one key exception – inflation.

Growth and demand conditions look to be slowing, with core-aged employment falling by -31.3k, manufacturing sales dropping by -1.7%, and core retail sales declining by -0.8% in the most recent reports. Furthermore, continued employment growth has largely been a product of firms partially absorbing the recent influx of workers as opposed to a further tightening in the labour market. But inflation remains a sticking point, with both headline and core price pressures having ticked up in July and the BoC's timelier measure of inflation pressures remaining stuck at uncomfortably high levels. We expect the upcoming GDP report to undershoot the BoC's 1.5% forecast for Q2 and below-potential growth along with other signs of slowing demand to give officials enough confidence that a hike will be unnecessary in September. We still see no further hikes for the remainder of the cycle as the likeliest outcome, but given the vast amount of data set to arrive between the September and October meetings, we believe October's meeting poses the greatest risk to our terminal rate forecast should softening demand conditions fail to spark a resumption in the disinflationary process.

Eurozone

Hiking into recession

Eurozone economic data released over the course of August have generally painted a bleak outlook. Near-term sentiment and growth indicators suggest that an already ailing economy is set to slow further in the third quarter, and while this has translated into lower hiring intentions across all sectors, it has yet to substantially weigh on core inflation, wage growth, and firms' pricing behaviours. With services firms still reporting a strong passthrough of input costs to the final consumer, and flash core inflation measures for August continuing to pose a threat of inflation persistence, we now see the ECB hiking rates once more to a terminal rate of 4% in a move that will likely exacerbate the ongoing growth slowdown. We think such actions will give the Governing Council more confidence to take a pause in its hiking cycle thereafter, pushing the risk of an extension in the hiking cycle to December's meeting should progress on disinflation stall. However, by December we believe growth, inflation, and wage data for Q3 and the start of the fourth quarter will present a more stable case for the ECB to embark on an indefinite pause as by this point the eurozone economy will likely be on the precipice of or already in recession.

Australia

Hotter under the hood

Policymakers at the RBA surprised markets in August, holding policy rates steady at 4.1%. This was in line with our off-consensus call, in turn based on a view that the RBA was awaiting confirmation from the quarterly wage price data that the labour market continues to generate persistent inflationary pressures before raising rates once again. It is notable then that the wage price index published on August 15th showed pay grew by 0.8% in the second quarter, and 3.6% YoY. On both of these measures, this undershot expectations by 0.1pp.

But, the measure remains above its long-run quarterly average of 0.5-0.6% QoQ, and worryingly for the RBA the share of workers receiving the largest wage rises (between 4% and 6%) continued to grow and is now at its highest level since 2009. The same mixed messages are visible in the inflation data. While headline CPI dropped from 5.4% to 4.9%, well below expectations of 5.2%, underlying price pressures remain uncomfortably high. CPI ex volatile items and transport 5.8%, while the more timely 3mma metric shows progress remains slow at 5.1%. The strength in wage dynamics goes some way in explaining the continued stickiness in measure of underlying inflationary pressure and together with Q2's growth data showing an acceleration in the expansion, the data suggests that the RBA should remain on a hawkish footing. For that reason, we are once again off consensus in thinking that the RBA is likely to surprise markets, this time with a hike at the September meeting which would take the policy rate to 4.35%.

UK

One more for the road

The MPC delivered another 25bps of policy tightening at the beginning of August, a move that took Bank Rate to 5.25%. Our view is that they are not done yet either, though we do think they signalled that the end is near. Commentary by Chief Economist Huw Pill towards the end of the month, stating that the BoE prefers a "Table Mountain" profile for rates, adds credence to our view. Data releases seen in August have broadly supported our view too. The mixed bag of prints over the past month means a September hike is almost a done deal given signs of inflationary persistence are still present, particularly in wages and services price growth.

> "But interestingly, unemployment now lies just fractionally below the BoE's estimate of neutral, with much of the impact of monetary tightening yet to be felt."

Combined with signs of softening across forward looking growth and the labour market indicators, under our base case this should produce a more consistent cooling picture across the data points over coming releases. Whether or not this arrives before the November meeting is likely to be key for the BoE. Beyond monetary policy and inflation dynamics, signs of cooling have also been seen in growth conditions. However, despite a slowdown, it is notable that GDP figures continue to surprise to the upside, showing a modest 0.2% expansion in the second quarter. Granted, more forward looking PMI readings have also dipped, but they have not fallen off a cliff as in the eurozone, and suggest a recession this year remains unlikely. Given this context of positive growth and slowing price growth, we think there may be some cause for optimism around the state of the UK economy.

Scandis

Progress but not enough

Central banks in Norway and Sweden are yet to conclude their hiking cycles with decisions from both coming up this month. Hikes will be the order of the day, with inflation across the Scandi economies still too high for comfort. But neither look set to deliver a jumbo rate rise of 50bp. In Sweden's case, with headline inflation at 9.3% YoY, it is weak growth conditions that will weigh on the Riksbank's ability to act. The economy is expected to fall into recession this year after GDP data released in August showed the economy contracted by 0.8% QoQ in the second quarter. The krona though remains troubling. Growing rate differentials to the ECB and brewing growth concerns on the continent in particular have seen the Swedish currency sell off steadily, adding to inflationary pressures. Until central banks elsewhere stop hiking, it appears there is little that the Riksbank can do to stem the inflationary bleeding other than continue to deliver continued but underwhelming policy tightening. In Norway, inflation is lower and falling faster than expected, negating the need for a reacceleration policy tightening. Indeed, headline inflation fell to 5.4% in July, a full 1% down on the June figures. Combined with growth conditions flatlining in Q2, there is growing speculation that this could be the final Norges Bank hike of this tightening cycle.

Japan

More to come, eventually...

The key concern for the Japanese economy, and for the BoJ, remains ensuring that inflation is embedded in the economy on a sustainable basis. On this front, policymakers had seen sufficient progress so far to ease yield curve control further at the end of July, despite their publicly aired reservations. As expected, this has seen the yield on JGBs rise. But, having intervened in the immediate aftermath to contain the fall in JGBs, action from the BoJ has been notably absent recently. Instead, JGBs have served as an escape valve for selling pressure on the yen, and vice versa, meaning yields have risen slowly while the yen sold off in tandem, before both stabilised around current levels. In terms of future easing though, the outlook is more uncertain. August brought a mixed picture on the outlook for the evolution of underlying inflation pressures. On the one hand, price growth remained stable in the July data at 3.3% YoY and excluding food and energy components it actually rose 0.1pp to 4.3%. On the other hand, labour cash earnings fell to 2.3%, undershooting expectations by 0.7pp, whilst the jobless rate surprised to the upside, rising to 2.7%. Although there are hawkish undertones to the labour market dynamics, the readthrough of the headline measures is consistent with the story told by BoJ policymakers; that even though inflation is high now, they also expect it to fall towards year end. And whilst expectations are still for a rebound in price growth in 2024,

this remains highly uncertain. In this context, with the BoJ's new yield cap not binding and inflation likely to fall, there seems limited urgency but plenty of risk that comes with further policy normalisation. Therefore unless markets choose to test the BoJs YCC framework again, we expect the BoJ to try and wait until certain inflation is sustainably embedded, likely in 2024, before taking the next steps towards normalising monetary policy.

In comparison, the scissors are out in the EM space

Whilst late cycle dynamics play out across much of the DM complex, in emerging markets rate cuts are increasingly front-of-mind alongside the prospects for Chinese stimulus. Commodity exporting emerging markets in particular would get a boost if China ultimately resorts to more typical economic stimulus, though all would likely benefit from the improved outlook for global growth. But in the absence of this fiscal package, which isn't necessarily forthcoming this year, policy loosening is likely to remain the main story for EM traders. Similar to our view on G10 currencies, we maintain a preference for quality in the EM space, with MXN standing out as notable long, while BRL and ZAR should benefit the most on any Chinese stimulus. In the absence of such measures, South Africa's unfavourable albeit improving fundamentals mean the rand is likely to languish without positive external developments, while we think BRL downside will be contained as the real's real rate profile remains attractive during this early part of the easing cycle. In Turkey, although the CBRT's decision to raise rates by 750bps was a welcome development for the lira, we are hesitant to interpret this move as an acceleration in the return to a more orthodox economic regime given it took place after repeated guidance by Governor Erkan that the adjustment phase would be "gradual". Instead of second guessing the central bank's reaction function, we prefer to stay focused on the fundamentals which remain weak and should lead to further TRY depreciation. However, with real rate differentials now much narrower, we expect the pace of lira depreciation to slow from here. Meanwhile, in the CE-3 space, premature rate cuts in Poland and the Czech Republic should result in further weakness versus the euro, while an extension in the NBH's easing cycle is likely to result in a continued unwind in short EURHUF carry trades.

China

Fixing the bearish sentiment

Within the EM complex, developments in China have been more influential that US fixed income markets, although both contributed to a broad sell-off in EM FX over the past month. In China, the story has been one of persistent growth downgrades. Headlines around the stability issues within from the shadow banking sector and the property market have combined with weak data and persistent policy easing from the PBoC to weigh on overall sentiment. Actions by the PBoC aimed at stabilising the economy and the deterioration in sentiment, however, merely added fuel to the fire as they underscored concerns that the economy is currently set to miss its 5% growth target. In markets, this played out primarily through USDCNY rising to the 7.3 handle, while local equities were also hit. This resulted in the PBoC intervening in FX markets by draining offshore liquidity, re-introducing a sizable countercyclical factor in the daily fixing, and instructing state banks to sell dollars in a quasi-intervention effort. Meanwhile, in equity markets, speculation was rife that the "national team" were once again mobilised to prop up investor sentiment. While these measures stabilised the ship, leading the onshore yuan to close out the month below the 7.3 handle, they did little to address the root cause. This became evident towards the end of August, where an improvement in the composite PMI in August and a decline in US Treasury yields failed to stimulate significant downside in USDCNY. The reluctance by markets to fade the recent rally in USDCNY on these marginal improvements, even as further upside is likely capped by the PBoC, suggests that the yuan is likely to remain in current ranges until investor sentiment improves.

CE3

Reaching a crossroads

Across CE3 economies, monetary easing is expected to be delivered this year, and in some cases perhaps as soon as this month. All three countries were heavily affected by the Russian invasion of Ukraine, leading to a sharp downturn in growth and a spike in inflation. Now though, having raised policy rates well into restrictive territory, central banks appear to have gotten price growth under control. Annual CPI increases are well down off the respective peaks, with month-on-month inflation rates of just 0.2% in Poland, 0.3% in Hungary and 0.5% in Czech Republic. Given that inflation is trending down rapidly, the balance for central banks is now shifting towards supporting a nascent economic recovery. Granted there have been signs of improvement already, with only modest Q2 contraction in Hungary and 0.1pp of growth in the Czech Republic. Poland too has also seen some green shoots of recovery appear, despite a sharper than expected contraction in the second quarter. But this is far from the kind of robust improvement policymakers would like to see, placing increasing emphasis on the need for policy easing. Indeed, Hungary is set to end emergency policy measures in September, with the effective policy rate falling to 13%.

> "With an election in Poland coming up on October 15th, rate cuts look imminent there too, and has been increasingly discussed by members of the MPC."

The Czech National Bank in contrast has been more reticent to comment on policy easing, but even they have officially called an end to their tightening cycle now, a move that puts rate cuts on the horizon. For currency traders, widespread policy easing in the CE-3 space is likely to weigh on previously popular carry trades, and with central banks easing policy to support growth, expectations of rate cuts could be inflated by any signs that the eurozone is tipping into recession in 23H2. With the market focus on improving or firm economic fundamentals, dynamics in CE-3 economies suggest further bearish price action should prevail even as external balances improve.

LatAm

MXN remains the crown jewel

As has been the case for much of the year, the prospect of policy easing in Latin America comes in spite of solid economic momentum. In Brazil, the BCB has already started the cycle, cutting the Selic rate by 50bps compared with our expectation of 25bps. Notably, a decrease in interest rates has been a desire of the new government, meaning that the economy is being boosted not just by the policy loosening, but is also benefiting from calmer political waters. Nevertheless, despite price growth of c.4% being well within the BCBs inflation target band, the risks of a pick-up in inflationary pressures remain on the table. This is something that traders and the BCB itself are aware of and which is why year end Selic rate expectations are currently at 11.25%, only 200 basis points below the peak rate. Mexico too continues to experience strong economic growth with Q2 GDP showing an expansion of 0.8% QoQ. Banxico however is unlikely to cut rates imminently, with core inflation still running at 6.6% YoY in July. Under our expectation that growth will hold up, not least due to the Mexican economy's high exposure to an outperforming US, we now think that Banxico will delay any easing until 2024. For FX markets, we expect to see MXN to continue to outperform BRL for this reason, however, we don't suspect significant BRL depreciation as the currency's carry appeal remains attractive in these early stages of the easing cycle. Furthermore, given the real's underperformance in the past month, we think BRL remains a prime candidate alongside ZAR for an improvement in sentiment over China's growth profile.

Elsewhere in the EMs

Out of whack

Amongst other notable emerging markets, Turkey remains an outlier alongside South Africa. The former saw a surprisingly large increase in policy rates last month of 750bps, taking the main policy rate to 25%, as the new central bank governor Erkan attempts to return to an orthodox monetary policy stance. Whilst in the longer term this is a necessary adjustment, it is likely to come with some growing pains, with inflation currently out of control. Price growth was close to 10% in July month-on-month, and though GDP continues to expand this is unlikely to last, with the degree of monetary tightening needed to cool inflation likely to crush the economic growth in the process. In contrast, continued economic mismanagement in South Africa has produced a stagflationary dynamic that is preventing the central bank from using monetary tools to support the economy or prop up the rand. Given there are few signs that this will be remedied soon, the outlook for the country looks set to remain grim.

DXY

The path lower has narrowed

The dollar posted sizable and indiscriminate gains once again in August, as growth differentials widened and real rates remained supportive. We expect the dollar to remain underpinned by these dynamics in the near-term, as Chinese officials battle with fuelling economic growth by incrementally tweaking policy tools, the ECB has to hike rates further despite ongoing growth concerns, and the US consumer continues to show little sign of fatigue. While inbound US data is likely to continue supporting the view that the Fed has engineered a soft landing and no further hikes are required in Q4 – a dynamic that should weigh on nominal Treasury yields, overall rate volatility and the dollar as a result – we don't expect this to durably weigh on the dollar. In fact, given the recent widening in growth differentials and bleak prospective capital returns outside of the US at present, we have pushed back our call for the DXY index to fall below the 100 handle to beyond the 6-month horizon.

"While there remains a path for a weaker dollar over this time period, it has narrowed considerably in the past month."

In order for an earlier broad-based sell-off in the greenback, we would need to see a considerable cooling in US data, such that the risk of an extension in the Fed's hiking cycle is priced out and expectations of 2024 rate cuts rebuild to their summer peaks, all without sparking recession concerns and a haven dollar bid. However, this looks unlikely until early 2024 based on the current pace of growth and the durability of the US consumer. An improvement in growth conditions outside of the US also poses a risk to our upgraded dollar call. This risk largely lies with China embarking on more substantive growth measures towards year-end given the outlook for the eurozone looks unlikely to improve in the near-term. However, given the preference by Chinese officials to support the economy through peripheral tools, fine-tuning the economic slowdown so to speak, the prospect of more substantive stimulus remains a tail risk.

CNY

PBoC defence unlikely to be broken

Efforts by the People's Bank of China to stabilise the slide in the yuan have proven effective over the course of the month, leaving USDCNY to trade below the 7.3 handle at month-end. While we don't question the ability of China's authorities to defend the yuan given their ample firepower, their ability to address the root cause of the depreciation is more questionable. Actions taken so far to support the Chinese economy have yet to gain significant traction, and while manufacturing PMI data has recently improved, it isn't necessarily indicative of an economy that can easily achieve this year's 5% growth target. The market's willingness to fade any dips in USDCNY below 7.3 on the back of more support measures exemplifies this. Under our base case that Chinese authorities will continue to ease incremental policy measures to fine-tune the slowdown and achieve their 5% growth target, we now expect USDCNY to trade close to the PBoC's perceived line in the sand of 7.30. Risks to this view are largely tilted to the downside on slowing US growth data and more sizable growth stimulus. Further out, we now don't expect USDCNY to retrace back to the 7.00 handle until 2024, when growth differentials should have normalised, cyclical pessimism bottoms out, and the prospect of DM policy easing comes into scope.

EUR

The top is in

Sentiment around the eurozone economy has deteriorated considerably over the course of August. Growth conditions are now seen as stagnant at best, with PMI data suggesting a recession in Germany is now likely, and that some other eurozone nations may face similar fates. Meanwhile, progress on the inflation front has proven slow. While a marginal shift in the tone of ECB Board Member Isabel Schnabel's commentary and a slowdown in eurozone core services inflation led markets to price out the prospect of an ECB hike in September towards the end of the month, we think the central bank is more likely to hike than hold, primarily because the bar to resuming its hiking cycle at a later date should inflation prove too sticky will be too high. An ECB hiking rates to 4% into an economic outlook that is stagnant at best is an undesirable outcome for prospective capital returns on the continent. We expect this dynamic to outweigh the positive impact an ECB hike will have on narrowing nominal rate differentials, and as such, think the increasingly bearish sentiment around EURUSD within the real money community is well placed.

"Given our base case outlook for the eurozone economy and our view that growth in the US will continue to be robust, albeit weak enough to prevent the Fed from further hikes, we now think the 1.1276 level recorded mid-July marks the top for EURUSD this year."

While softening data in the US will likely cause spurts of EURUSD strength, we would look to fade any rally north of 1.10. In our view, only a softening in US data that rebuilds rate cut expectations for the Fed in 2024 to levels seen earlier in the summer or a more tangible fiscal package out of China can justify a more durable rally above the 1.10 threshold and threaten the current year-to-date high.

While we have downgraded our one-month and three-month EURUSD forecast to 1.07 respectively, primarily based upon the deterioration in the growth outlook, we believe EURUSD will remain in current year-to-date ranges. A breach below this year's low of 1.05 remains a distant possibility in our view, one that likely requires a much harsher economic recession in the eurozone.

GBP

Improving fundamentals

With the Bank of England not yet finished tightening monetary policy, it is interest rate differentials that continue to hold the key for the pound. Given our view that underlying inflationary pressures should cool markedly over the coming months, we expect a final hike from the Bank of England in September, before confirmation of softening in wage data and services inflation allows policymakers to terminate hiking in November with Bank Rate at 5.5%. This would ultimately see the BoE undershoot market expectations, which currently anticipate two further hikes, placing depreciation pressure on the pound. But this is likely to be in the form of a sustained downward pressure rather than a sharp impetus as markets slowly align with our view.

Weighing against this, we expect markets to place more emphasis on currency fundamentals, especially as it becomes clear that monetary policy will remain on hold for some time across developed markets. On this point, the UK looks set to escape recession, merely stagnating over coming months. This is a vast improvement from imminent and deep recession calls early in the year and should leave the UK attractive on an international comparison. With UK assets already looking cheap on many metrics, the relative outperformance on growth should help channel portfolio flows into the UK, providing some support for sterling. Net-net, this suggests renewed upside against the euro over coming months, whilst upside against the dollar is likely to be more limited.

However, timing of these dynamics is key. If markets coordinate on one story before the other, then significant breaks in the pound to either the upside or downside could result. Not to mention, risks to our base case are significant, and more pronounced than for many other major currencies. Whilst our UK view is predicated on a slow down in wage growth as signalled by other economic indicators, if this fails to materialise then the BoE will find themselves in the same basket as the ECB. This means hiking the economy

into a recession and consequently tanking the pound. Equally, a soft-landing scenario in the UK is not out of the question yet, even if it looks unlikely to us as of now. If realised, this should see the pound appreciate significantly with more benign economic conditions supporting significant inflows into UK assets.

CAD

Disconnected from fundamentals

The loonie sold off considerably over the course of the month, declining by -2.7% against the dollar. While we can point to a couple of stories that partially explain the move, none of them fully explain the sustained slide over the month. The narrative in markets has been one of US exceptionalism, where America's strong growth and low inflation stand out from the rest of the world, which is increasingly facing a stagflationary environment. China's economic woes have also led to a sharp deterioration in global risk sentiment, the second key theme for global markets. But while it makes sense in this dollar supportive environment for CAD to have weakened, it is highly surprising that the loonie has underperformed the euro and pound, especially since Europe and the UK are seeing both higher inflation and weaker growth. For most of the year, the loonie has been a defensive currency against dollar rallies, sustaining milder losses than other high-beta currencies thanks to its better relative growth profile and trade links with the US, but this wasn't the case in August. Looking at the cross-asset space, there is little evidence to explain the loonie's underperformance either.

"Yield spreads with the US have been mostly stable in Canada, even during the duration sell-off mid-month, while declines in the S&P 500 and TSX—the equity indices most closely linked to the loonie—have been far smaller than the sell-offs in Europe and Asia."

All told, we think the loonie's sell-off is overdone relative to its fundamentals and look for a partial retracement to take place in the coming month. However, unlike other analysts, we don't think the BoC's September meeting will be a catalyst for the CAD recovery. Granted the progress in returning inflation back to target continues to stall, but we think the BoC will take comfort in its latest efforts and the softer growth data to pause it's hiking cycle once again. Over the medium-to-longer term, we maintain our bullish view on CAD on the expectation that the US will avoid recession, the Fed will ease policy rates before the BoC, and the dollar will structurally depreciate.

CHF

Alpine peaks

Whilst our EURCHF call for the past month has largely materialised as expected, we are taking this opportunity to revise down our projections further out, especially following some notable developments in the past month and with a key SNB decision on the horizon. On the former, inflation data showed signs that price growth is not just cooling, but is doing so faster than expected. Given this, markets have now largely priced out the prospect of any more SNB hiking and anticipate seeing rates on hold over the entirety of our forecast period, in line with our base case expectations. But a continued downward trend for inflation, a move suggested not just by the continued falls in CPI, but also modest expected wage agreements and weak European growth outlook, could see the SNB willing to accept a modestly weaker Swiss franc to hedge against the risk of falling into outright deflation. With this in mind, we have likely seen the peak in CNF strength for now in our view. But weighing against any depreciation pressure is the prospect of a Eurozone recession, in line with our updated base case projection, which will likely trigger a modest CHF haven bid and put a floor under the Swiss currency. Therefore, given these competing forces, we now expect to see the franc to trade sideways in the 0.96-0.98 range over our forecast period. That being said, there remains the risk of a surprise rate hike at the upcoming meeting, or for a more severe than anticipated slowdown in European growth. Both of these scenarios could see this range set lower, though we don't see much impetus for a sustained directional move in either case given the deflation risk.

Scandi FX

Recovery on the horizon

A choppy ride looks to be in store for Scandi currencies over coming months, though we think a broad appreciation trend should ultimately emerge. On the domestic front, neither the Norges Bank, nor the Riksbank are done hiking rates, meaning that monetary policy will remain a driver for Scandi currencies for longer than many other G10 FX markets. Whilst ultimately this should prove supportive for both NOK and SEK, it may well have to wait for other central banks to stop hiking, and rate differentials to close, to produce meaningful appreciation moves. In the short term, limited liquidity has seen EURNOK stuck at levels that we think look expensive, and expect to see a reversal of the weakness over the coming month. For Sweden in contrast, a shrinking economy and continued housing market concerns are likely to leave SEK a relative underperformer, as will current feedback dynamics between the weakening currency and inflation persistence. But with most of the bad news now baked in by markets, and with the ECB to imminently terminate its hiking cycle after September's meeting, this feedback process should go into reverse over coming months, meaning we expect SEK to outperform NOK over the medium term.

That being said, market developments in the past month have highlighted anew the importance of global growth conditions as a key driver for EUR-Scandi crosses. Both NOK and SEK were amongst the weakest performers over the past month, as markets were largely left to trade a narrative of weaker growth conditions in Europe and China. Equally, on occasions where markets began discounting this story, the biggest rallies were typically in Scandi currencies as well. Given this, whilst this narrative still has several more chapters to run, we expect that under our base case we will see NOK and SEK upside against the euro over the coming year, though if recent price action is anything to go by it will likely be an uneven climb.

Antipodes

Feeling China's chills

AUD and NZD have understandably underperformed in the G10 complex this month given rising concerns over China's growth outlook and the continued absence of the previously rumoured fiscal package. With Chinese officials continuing to favour incremental policy tweaks to stimulate the economy, substantial upside in Antipodean FX is unlikely in the coming months. However, downside may also be limited as sentiment over China's growth outlook may be reaching a trough, real rates in New Zealand are set to improve, and we expect a further rate hike from the RBA in September. Reflecting this, we see incremental upside in both Antipodean currencies in the near-term, but for the bulk of the rally to be back-loaded until 2024 when cross-asset risk conditions stabilise and the Fed begins to eye its easing cycle. Discounting dollar dynamics, we expect AUDNZD to trade higher in the near-term as markets continue to underprice the risk of an RBA hike, before the cross returns to current ranges as Fed easing benefits NZD marginally more than AUD.

LatAm

Staying bullish for now

August was an important month for high beta LatAm currencies, as domestic economic developments constitute somewhat of a turning point for these currencies over the medium-term. In Brazil, the Central Bank of Brazil decided to take the first step in monetary easing after eleven months of holding the Selic rate at a level of 13.75%. While the decision to start cutting the policy rate wasn't surprising for markets, the size of the rate cut was. After months of hawkish rhetoric based on concerns that inflation would tick higher in the second half of the year, the BCB succumbed to pressure and cut rates on the top-end of expectations by 50bps. Markets now expect the Selic rate to end the year at 11.75%, constituting another three 50bp cuts this year. While in the near-term, given how positive real rates are, this shoudn't way too heavily on BRL, especially as it further supports improved relations between the BCB and the Lula administration. Political noise in Brazil has also been reduced by the confirmation of Lula's fiscal plan by Senate and Congress. In contrast, in Mexico the prospect of rate easing has been pushed back into 2024. While the disinflationary trend since the start of the year remains in tact, there is now a broad consensus, not only within Banxico's Board of Governors but also in international markets, on the need for the Bank to keep rates high for longer, with recent growth data supporting this view. Taken together, we remain bullish on BRL and MXN in the short-term, especially as recent growth concerns in China and actions by Banxico to reduce the size of its FX hedge programme have created favourable entry levels once again. For BRL specifically, while we think the real will benefit the most from any increased signs of Chinese stimulus, improving economic fundamentals and reduced political hysteria should lead to cotntinued BRL appreciation even as China growth concerns remain. However, we note that the risks to our bullish MXN and BRL calls remain elevated. On the former, saturated positioning and deteriorating cross-asset risk sentiment raises the risk of a more pronounced unwind in carry-trade positions. Meanwhile, in Brazil, more aggressive policy easing remains a credible risk for markets to contend with.

CE3

Depreciation nations

Whilst CE3 FX has been relatively insulated to the recent developments in China and the US compared to other eurozone periphery currencies, the opposite is true when considering conditions in the Eurozone. Granted, this has seen our August CE3 forecasts largely play out in the past month. However, a September rate hike from the ECB, currently unexpected by markets but a key part of our base case, now looks set to weigh on CE3 FX in the short term. As will a more significant downturn in the Eurozone that we now project on the back of sliding growth indicators, which should continue to add depreciation pressure over a longer time horizon. These moves will likely be aided by domestic factors, which should see central banks easing policy rates over coming months. But despite our projection for CE3 weakness, data showing the eurozone is unlikely to enter a deep recession should preclude any rapid selloffs. Instead, the path looks set for a slow grind higher for EUR-CE3 crosses.

In Poland specifically, having foregone the dovish commentary and talk of rate cuts for several months, NBP members resurrected this with a vengeance in late July and into August. This development saw the zloty climb through much of last month, as markets began to take seriously the prospect of rate cuts this year, coming perhaps as soon as September. In particular, this was given extra credence following the announcement of a mid-October general election, with the Central Bank governor seen as a key ally of the incumbent government. In our view a September rate cut looks a little early for now, with October a more likely start date for the cutting cycle. This should see the current turnaround in the zloty sustained with the currency continuing to weaken over the coming twelve months.

Meanwhile in the Czech Republic, the central bank finally declared an end to their hiking cycle. Whilst this is not news in and of itself for markets, especially given the CNB has not moved rates since June 2022, it is notable in the sense that markets are now free to turn their attention towards policy easing.

From an FX perspective, it was also interesting that the CNB chose to rule out currency market interventions. Having previously signalled a willingness to prevent EURCZK rising above the mid 24 mark, it suggests to us that we could well see this level breached on a sustained basis towards the end of our forecast period. Despite this, we still see the CNB as the most hawkish of the CE3 central banks, and therefore look for a relatively slower policy easing and more limited depreciation in the koruna as a consequence.

It is in Hungary though where markets have seen the most from a CE3 central bank to date, with the NBH continuing to normalise their emergency policy measures. August saw the fourth successive 100bp cut in the effective policy rate, and we are pencilling in a final 100bp reduction in September to align the effective rate with official policy tools. Beyond that point, the outlook is still uncertain, though it seems likely that an easing through official policy tools will follow in Q4 this year. When and how fast this comes will be key for markets, but for now we expect to see the NBH loosen broadly in line with peer economies. The forint however should be the biggest loser amongst CE3 currencies. Having benefited from attractive carry traits over the past year, policy easing should send this process into reverse, implying that HUF should reverse the most as carry positions progressively wash out.

Forecasts

Currency Pair	1-month (30th September 2023)	3-month (30th November 2023)	6-month (29th February 2024)	12-month (31st August 2024)
G10				
EUR/USD	1.07	1.07	1.10	1.14
USD/JPY	147	150	140	135
GBP/USD	1.26	1.28	1.31	1.34
USD/CHF	0.90	0.90	0.89	0.86
USD/CAD	1.345	1.34	1.32	1.30
AUD/USD	0.66	0.665	0.68	0.69
NZD/USD	0.60	0.60	0.63	0.65
USD/SEK	11.2	10.7	10.2	9.6
USD/NOK	10.6	10.2	9.7	9.2
DXY	104.8	104.6	101.3	98.0
Emerging Markets				
USD/CNY	7.3	7.3	7.0	6.8
USD/INR	82	82	80	80
USD/SGD	1.35	1.35	1.33	1.33
USD/ZAR	18.5	18	17.5	17
USD/TRY	27.5	28	30	25
USD/PLN	4.21	4.25	4.18	4.12
USD/HUF	360	369	364	360
USD/CZK	22.6	22.8	22.4	21.9
USD/BRL	4.8	4.8	5.0	5.1
USD/MXN	16.75	17.2	17.5	17.6
Euro Crosses				
EUR/GBP	0.85	0.84	0.84	0.85
GBP/EUR	1.18	1.20	1.19	1.18
EUR/CHF	0.96	0.96	0.98	0.98
EUR/CAD	1.44	1.43	1.45	1.48
EUR/SEK	12.0	11.4	11.2	11.0
EUR/NOK	11.3	10.9	10.7	10.5
EUR/TRY	29.4	30.0	33.0	28.5
EUR/PLN	4.5	4.55	4.6	4.7
EUR/HUF	385	395	400	410
EUR/CZK	24.2	24.4	24.6	25.0
EUR/BRL	5.14	5.14	5.50	5.81
EUR/MXN	17.9	18.4	19.3	20.1

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