MillTechFX
by Millennium Global

The **2023 Currency Management Guide** for forward-thinking Fund Managers & CFOs

Introduction

Currency volatility was one of the dominant macroeconomic trends of 2022. Throughout the year, the value of currencies peaked and troughed in response to factors such as high inflation, rising interest rates and geopolitical issues.

We saw the dollar surge to **20-year highs,** while the **pound** and **euro** slumped to 50 and 20-year lows respectively, only to then substantially bounce back in the last months of the year. All of this uncertainty and unpredictability had a major impact on fund managers across the globe.

The pressure on fund managers – a segment of the market that has historically struggled with its FX setup - intensified against the rising threat of currency movements negatively impacting their investment returns.

This has placed the importance of having an FX strategy firmly back in the spotlight, with 93% of asset managers believing that FX is significant to their business.

Many are reviewing their current FX setup, from price discovery to settlement, and adjusting their hedging programmes to add in a layer of agility and flexibility so they can readily adapt to the everchanging business environment.

With economic changes such as potential recession and further interest rate rises on the horizon, several finance decision-makers at fund managers should consider prioritising FX risk management to improve performance, deliver sustainable growth and, ultimately, protect their returns.

In our 2023 Currency Guide for CFOs at Fund Managers, we share information on what these macroeconomic changes could be and what fund managers should focus on in the year ahead.

Macroeconomic outlook

When considering their key priorities for FX risk management in 2023, it is important that finance and treasury teams first gain a deeper understanding of the current global macroeconomic backdrop so they can monitor key developments closely and develop an effective strategy.

In its **Q1 2023 Global Currency & Macroeconomic Highlights report,** Millennium Global states that:

- US inflation is set to fall in the first quarter, mainly driven by supply side factors (energy and core goods) but then by shelter prices

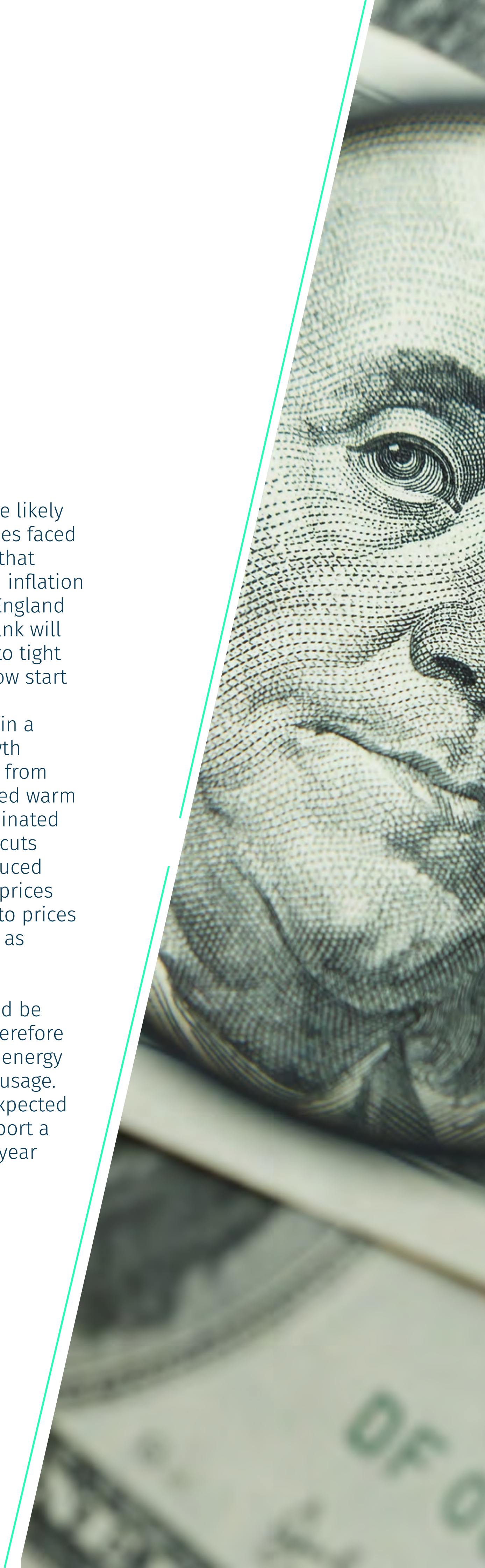
- There are clear signs that monetary tightening is impacting the economy. Although US growth should slow via the investment channel, the consumer should help the US economy avoid recession as falling inflation becomes a windfall to purchasing power

- A change in the Fed's reaction function will be important; a forward-looking approach allows them to react to disinflation in shelter prices and accept that wages will be the last price to slow

- Wider central banks are likely to finish their hiking cycles faced with sufficient evidence that growth is weakening and inflation is peaking. The Bank of England and European Central Bank will lag behind the rest due to tight labour markets and a slow start

- The euro area is likely in a mild recession with growth expected to slow further from here. However, unexpected warm weather has almost eliminated the likelihood of output cuts this winter and even reduced the expected rise in gas prices in Q2 2023, with the risk to prices actually lower from here as weather normalises

- China reopening should be relatively gradual and therefore limit any uplift to global energy demand from industrial usage. More policy support is expected to be announced to support a growth target of 5% this year



Currency outlook

Now that we've established the macroeconomic outlook, let's drill into Millennium Global's macro team's opinions on what this means for currencies.

- Correlations show that we are in a "top-down" environment where global inflation is still the primary driver of equity, bond and currency markets
- The US bond market has somewhat front run the economic view of falling inflation, but there's still scope for US yields to fall further
- This puts downward pressure on the USD helped by improving sentiment: inflation falling, China reopening and the likelihood of another terms of trade shock receding
- The outlook for JPY and EUR is positive as they have valuation support and benefit from stable-to-lower commodity prices. The euro should be supported by a hawkish ECB which has some scope to "catch-up". This could also see CHF weaken (versus the euro) as gas prices move lower
- Millennium Global's macro team are more cautious on equity-linked currencies, AUD and GBP, given medium term US recession risks and dovish risks around domestic interest rate pricing
- They are also expecting CAD to fall, given an earlier end to the hiking cycle from the BoC and lack of support from commodity prices
- In EM, they are positive CNH as China reopening suggests a more reflationary environment going forward and neutral on BRL as the attractive carry offsets domestic fiscal and recession risks

Key currency views

Negative US dollar (USD): Inflation is still dominant theme in a top-down market + US Dollar index still expensive as yield differential support reverses

The US inflation outlook is partially priced in bond markets but there is further room for yields to fall as the probability of higher yields driven by stubbornly high inflation recedes.

While inflation (not growth) remains the dominant driver of markets, the equity-bond correlation should stay positive – having important implications for equity driven FX (such as AUD, GBP) vs duration sensitive FX (such as JPY, CHF). This reflects lower inflation being the primary driver of Fed cuts rather than recession fears.

While the dollar has weakened, it remains expensive, particularly through the lens of the US Dollar Index. The risk environment has broadly become more supportive as central banks reduce the pace of tightening, China reopens (but not too quickly to negatively impact Europe) and a warm winter has bailed out Europe; significantly reducing the likelihood of another severe terms of trade shock.

The US is on track for a mild recession with a Federal Reserve that has signalled an unwillingness to cut interest rates. However, Millennium's macro team sees "soft-landing" dynamics at play over the first quarter with the US avoiding a recession as the consumer benefits from a boost to purchasing power, the labour market remains strong and a private sector that has a buffer that should avoid a quick retrenchment in spending.

Neutral British pound sterling (GBP): Benefits from supportive risk backdrop as US inflation falls but UK cyclical and structural vulnerabilities remain

Sterling has benefitted from the broad turn in risk sentiment and in particular, the FX correlation with US equities. US inflation is likely to fall over the quarter and should continue to support GBP from a yield differential and risk-sentiment point of view (as US yields move lower and equity risk is supported). Meanwhile, as global growth slows, energy prices should not act as an impediment to sterling appreciation.

The bottom-up view is less supportive of sterling. Firstly, UK growth is expected to underperform the US primarily due to the dispersion in real wage growth outlook as well as building fiscal headwinds. Secondly, nominal wage growth of 6% should keep the Bank of England hawkish in the near term and hiking into Q2. However, a terminal bank rate of 4.7% is already priced into bond markets.

Moreover, it is not clear that signs of further second round effects will be supportive of the currency given it will come as the cost of a more severe recession and in the backdrop of continued structural vulnerabilities.

Positive euro (EUR): Energy shock to take a smaller than expected toll on growth and ECB to remain hawkish despite recession

While the energy shock is taking a toll on growth, so far, activity has been resilient and Europe's ability to increase gas storage levels to 95% coupled with warm weather has offered enough buffer to get Europe comfortably through the winter. In the medium-term, the likelihood of a terms of trade shock similar to the one experienced in 2022 has significantly decreased. While gas prices are likely to increase again next summer, they are not expected reach levels registered last summer as the increase in other sources of energy supply, nuclear notably, should help in containing upward price pressures as well as a lacklustre rebound in Chinese economic activity.

Despite having increased rates by a 200bps thus far, the European Central Bank is lagging behind its hiking cycle. A tight labour market and persistently elevated inflation point to a continuation of rate hikes, though at a slower pace. Risks around the terminal rate are on the upside amid inflation stickiness, wages upward pressures and uncertainty around further energy shocks. While the relative growth dynamic should weigh on the currency, the relatively more hawkish stance from the ECB compared to the Fed should support the currency. Additionally, in the short term, there should not be any concerns related to fiscal stability and debt sustainability in Italy, that could have driven a negative euro sentiment.

Positive Japanese Yen (JPY): A valuation opportunity with good risk-reward and

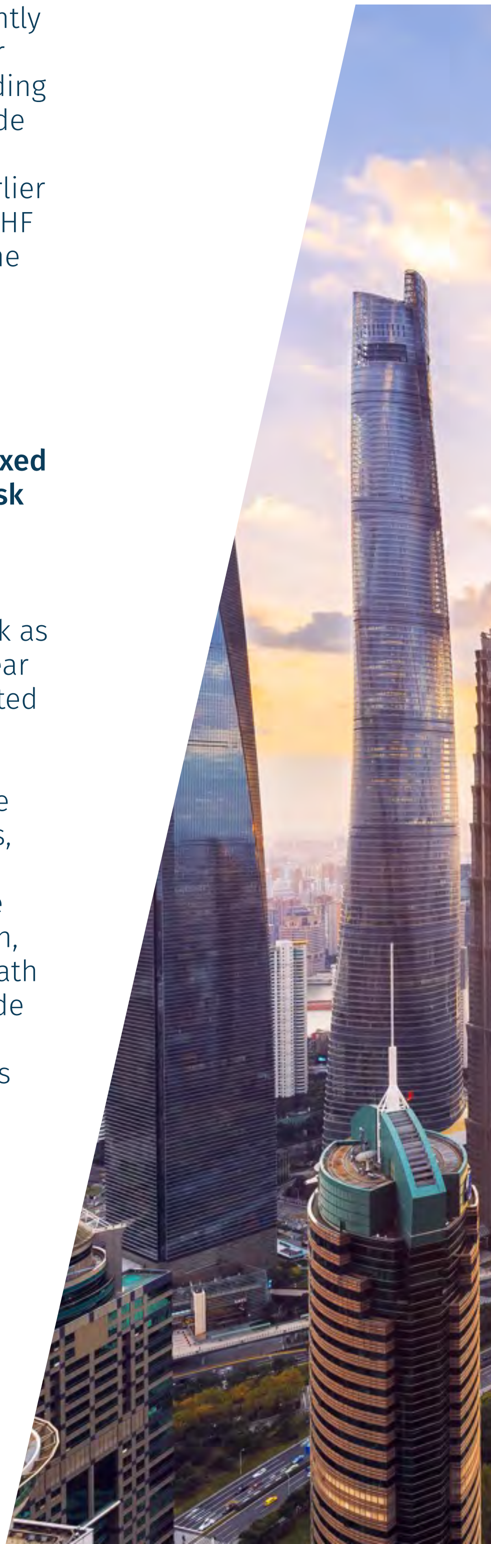
Despite its recent appreciation, the yen is still the cheapest currency in G10. Given the main driver of the yen continues to be relative yield differentials, US inflation and growth are likely to slow over the next quarter points to treasury yields moving lower. There is broad uncertainty in the economic outlook but see good risk-reward for the yen given the economic scenarios. While this view is premised on the US side of equation, the explicit forecasting of a "virtuous" inflation cycle from the Bank of Japan ("BoJ") is meaningful. Though there's not likely to be a change in yield curve control from the Bank of Japan next quarter, there is an expectation that Japanese inflation developments will generally support a normalisation in policy in the second half of the year.

Neutral Swiss franc: SNB normalisation almost complete

From a cyclical point of view, the relatively low inflation and wage backdrop suggest the Swiss National Bank (SNB) is nearly done with its hiking cycle, leaving the central bank to focus on monetary policy implementation. Millennium's macro team therefore take a slightly more dovish view than the market, which leaves them neutral on the Swiss franc versus the US dollar and slightly negative versus the euro. The latter should also be helped by the receding probability of another terms of trade shock (which benefitted the Swiss franc as a European safe haven earlier on in the year). This suggests EURCHF could drift higher, particularly as the SNB become more sanguine about the inflation outlook and therefore the associated pass through from currency.

Neutral Australian dollar (AUD): Mixed equity environment with dovish risk to RBA

Correlations suggest the Australian dollar remains a view on equity risk as well as yield differentials. In the near term, equity risk should be supported by lower US inflation however as growth slows (as the probability of a hard landing rises) this should be accompanied with equity weakness, particularly if the Fed are reluctant to cut interest rates. Ultimately, the Fed is likely to become more dovish, but this presents a likely volatile path for "Aussie". There are also downside risks to the RBA rate path, leaving Millennium's macro team neutral vs USD overall.



Negative Canadian dollar (CAD): No support from commodity prices and domestic downturn

The fall in commodity prices, which is the main driver of the Canadian dollar, should not be supportive of CAD. Additionally, there is likely to be a significant slowdown in activity, amid high inflation and ongoing housing market correction, that should weigh on the currency. The Bank of Canada (BoC) has reduced the pace of its tightening cycle in October and signalled, at its December meeting, a potential further step-down further out. Another smaller hike is currently reasonably priced for January, as inflation is likely to still show signs of stickiness. The BoC is expected to end its hiking cycle earlier than the Fed given a more frontloaded hiking cycle and a higher sensitivity of households to interest rates. Overall, commodity prices and domestic factors should not support the currency in the short-term.

Positive Chinese yuan (CNH): Reopening growth and sentiment supportive

In mid-November, China began the reopening process and policymakers are now signalling a focus on supporting growth. Low vaccination rates in the elderly and limited hospital capacity point to reopening being a gradual process with the economic reward likely in the second half of 2023. This is important for two reasons. Firstly, re-opening is likely to boost sentiment but keep a lid on energy prices and secondly, this limits the current account deterioration from outbound tourism. While the former is important for the broader inflation outlook, the latter should mean that the currency can strengthen as growth prospects and capital inflows improve. However, this is unlikely to be a smooth ride as investors digests poor incoming data and more covid cases.

Neutral Brazilian real: Tight financial conditions and high indebtedness

A combination of significant financial tightening, highly indebted households, moderation in commodity prices and the fiscal uncertainty should drag the economy into a recession in the first quarter. On the fiscal front, the Senate approved Lula's proposition to increase the cap on spending, allowing for expenditures above BRL200 bn in 2023. Uncertainty remains as the bill is currently waiting for lower house approval.

The Banco Central do Brazil (BCB) kept rate unchanged at 13.75% in December as services inflation should take longer to ease. They also reiterated their concern over fiscal policy and its inflationary consequence. As such, the BCB could keep rates higher for longer to tame inflation and sustain the currency. In that context, Millennium's macro team take a neutral view on BRL versus USD as high nominal rates should broadly offset the negative currency drivers.

For more in-depth macroeconomic analysis and currency opinions from Millennium Global, read the full Q1 report here.

FX trends in 2023

From the research above, it's clear that FX volatility is again trending upwards, and we expect this to continue throughout 2023, driven by potential economic and political factors.

So, in this context, what should Fund Managers keep in mind in 2023?

In FX, we have seen a strong focus on three themes in particular: automation, outsourcing and ESG.

1. Automation

For many fund managers, FX processes can be manual, cumbersome and time-consuming.

FX price discovery can often involve multiple phone calls, emails, or online platforms to log in to just to get comparative quotes from your counterparties. Because the market is constantly moving, price discovery requires a team of people calling, emailing and logging in simultaneously before they can collectively decide who offered the best quote. And this is just one stage in the long-winded process of booking and settling an FX trade.

All of this internal, manual and siloed communication can be extremely inefficient. Many organisations execute tens or hundreds of trades every month with different products and mechanics, which may make the entire process a huge drain on time and resources. Despite it taking fund managers on average **nine months** to set up their FX execution infrastructure, only **15%** believe that their set up is best in class.

As a result of these challenges, many fund managers are increasingly exploring simple, tech enabled solutions that digitalise these processes, with **84%** of senior finance decision makers surveyed looking into new technology and platforms to automate their FX operations.

With fund managers on the search for efficiency gains and cost-savings, moving away from traditional providers and legacy processes towards more automated digital infrastructure is likely to be a prominent trend in the coming year.

2. Outsourcing

Outsourcing has emerged as common practice across the financial services industry, and it is set to gain more traction in FX in the year ahead.

FX is one of the **largest and most liquid** markets in the world, but also one of the most complex. Setting up and onboarding new FX counterparties, centralising price discovery and navigating the post-execution phase often have their own complications and can be a huge administrative burden for fund managers, eating up time and resources.

Specialised external solutions can assist with these steps. Outsourcing can free up resources for more effective use elsewhere, enabling firms to dedicate more time to core business matters. Turning to a specialist often means that the end product is also more likely to be of higher quality, leading to improved execution, saving money in the long run.

There are still some barriers towards outsourcing, such as a perceived lack of transparency and the administrative burden of integration. However, the growing recognition that outsourcing – when done with the right partner – does not necessarily lead to a loss of quality or control means we can expect more firms to harness third-party services in 2023.

3. ESG

Environmental, Social and Governance (ESG) criteria has begun to play an increasingly important role in the FX industry. **58%** of fund managers believe that their FX counterparties must have strong ESG credentials while **36%** see it as an important consideration.

However, much of the emphasis to date has been on the first two letters of the acronym – 'E' (environmental) and 'S' (social), with 'G' (governance) often left lagging behind. There are several steps we can expect firms to take to improve governance. These include:

a) Compare market prices and rates in order to demonstrate best execution.

b) Implement ongoing, quarterly Transaction Cost Analysis (TCA) to highlight hidden costs – such as in the FX spread – and gain transparent cost oversight.

c) Work with providers that adhere to the Global FX Code (GFXC), which was designed to enhance integrity and best practice across the wholesale FX market.

d) Scrutinise the ESG credentials of partners and ensure that FX providers adhere to internationally recognised standards, such as the Principles for Responsible Investment (PRI).

As investors become increasingly driven by ESG criteria, more fund managers are likely to begin turning to providers that can demonstrate strong ESG credentials and are closely aligned to their