Q1 2023

GLOBAL CURRENCY & MACROECONOMIC HIGHLIGHTS

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MGI Economics

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Economic Views

- 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
- We see a change in the Fed's reaction function as being 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
- Meanwhile wider central banks are likely to finish their hiking cycles faced with sufficient evidence that growth is weakening and inflation is peaking. We see the BoE and ECB lagging behind the rest due to tight labour markets and a slow start
- The euro area is likely in a mild recession with growth likely 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 next year, 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. We expect more policy support to be announced to support a growth target of 5% next year

FX Views

- Correlations show that we are in a "top-down" environment where global inflation is still the primary driver of equity, bond and currency markets
- We acknowledge that the US bond market has somewhat front-run our economic view of falling inflation, but still see scope for US yields to fall further
- This leaves us negative on the **USD** helped by improving sentiment: inflation falling, China reopening and the likelihood of another terms of trade shock receding
- We favour the **JPY** and **EUR** 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
- We are more cautious on equity-linked currencies, **AUD** and **GBP**, given medium term US recession risks and dovish risks around domestic interest rate pricing
- We are negative **CAD**, given an earlier end to the hiking cycle from the BoC and lack of support from commodity prices
- In EM, we 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

Source: MGI Economics, all view are as of 16 December 2022

Key currency views

USD (-)

The dollar should weaken helped by lower yields and improving sentiment: inflation falling, China reopening and the likelihood of another commodity terms of trade shock receding

CAD (-)

Stable-to-lower commodity prices unhelpful given weak growth prospects and an end in the hiking cycle

BRL (0)

We see BRL suffering from fiscal uncertainty and recession. However, very restrictive monetary policy should support the currency

EUR (+)

Well placed to benefit from a weaker dollar: EUR has valuation support, should be helped by lower commodity prices and an ECB which needs to raise rates further

GBP (0)

Better risk environment should be supportive near term, but less so medium term as US growth slows. The UK cyclical and structural backdrop is still poor with downside risks to BoE rate pricing

CHF (0)

See a dovish SNB going forward but scope for EURCHF to move higher as gas prices fall and relative monetary stance vs ECB

JPY (+)

Still cheap with good risk-reward given the outlook for US inflation and downside growth risks

CNH (+)

Quite simply, domestic reopening is reflationary while limiting a drag from the services balance

AUD (0)

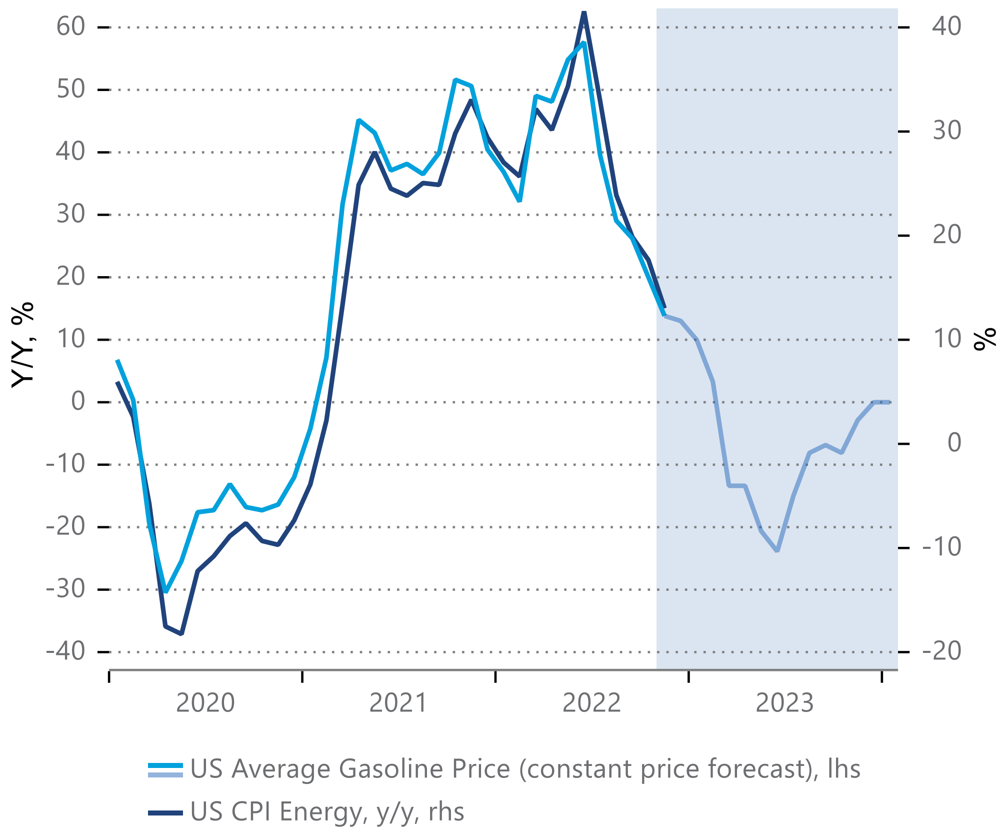
Equity environment mixed in the medium term coupled with dovish risks around the RBA

All views vs USD. Source: MGI Economics, 15 December 2022

Economic Outlook

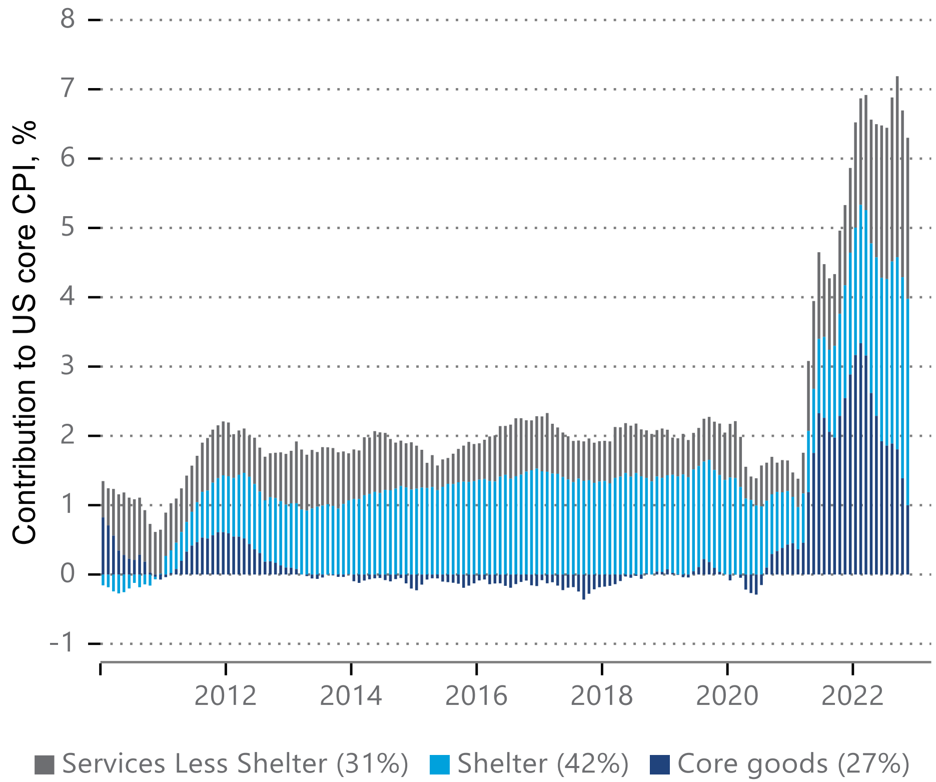
US core inflation crucial to Federal Reserve rate path

In Q1, energy will turn to drag on inflation



Source: Macrobond, MGI Economics, 15 December 2022

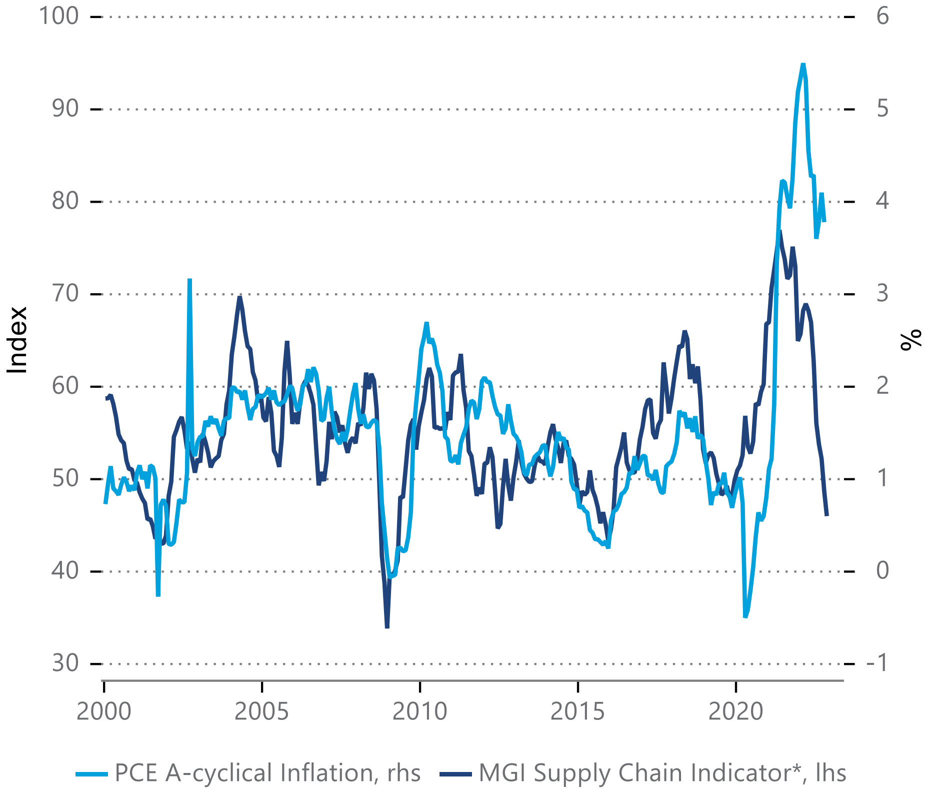
Driver of core inflation now services and shelter



Source: Macrobond, MGI Economics, 15 December 2022

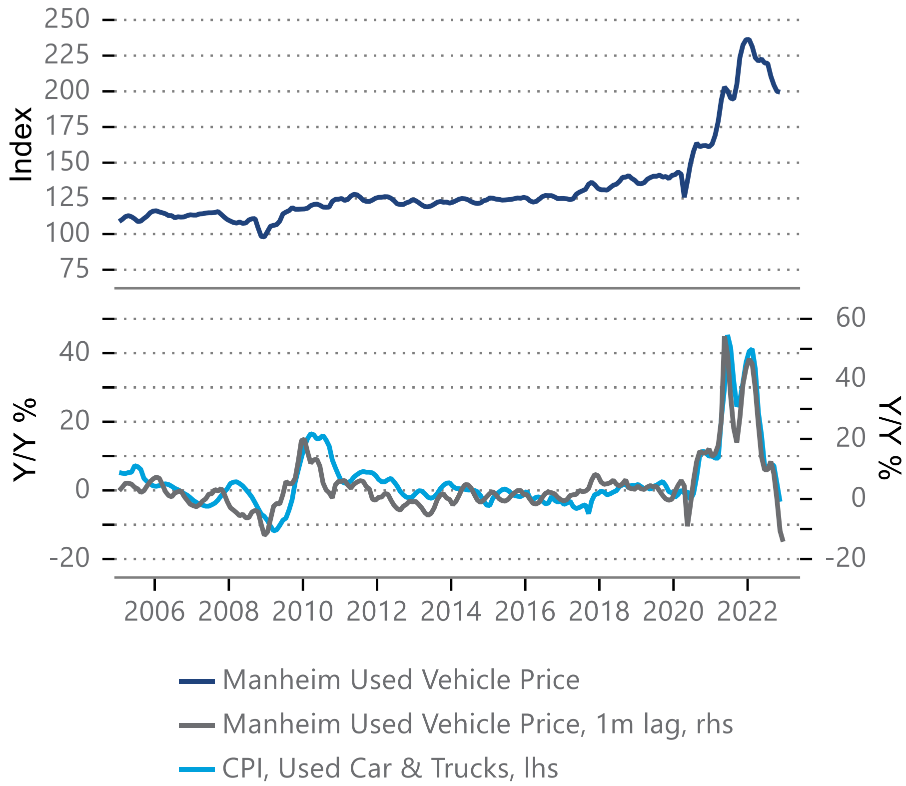
Ingredients for disinflation are here: Core goods

Supply chains have broadly normalised



Source: Macrobond, MGI Economics, 15 December 2022

Disinflation in the pipeline for autos



Source: Macrobond, MGI Economics, 15 December 2022

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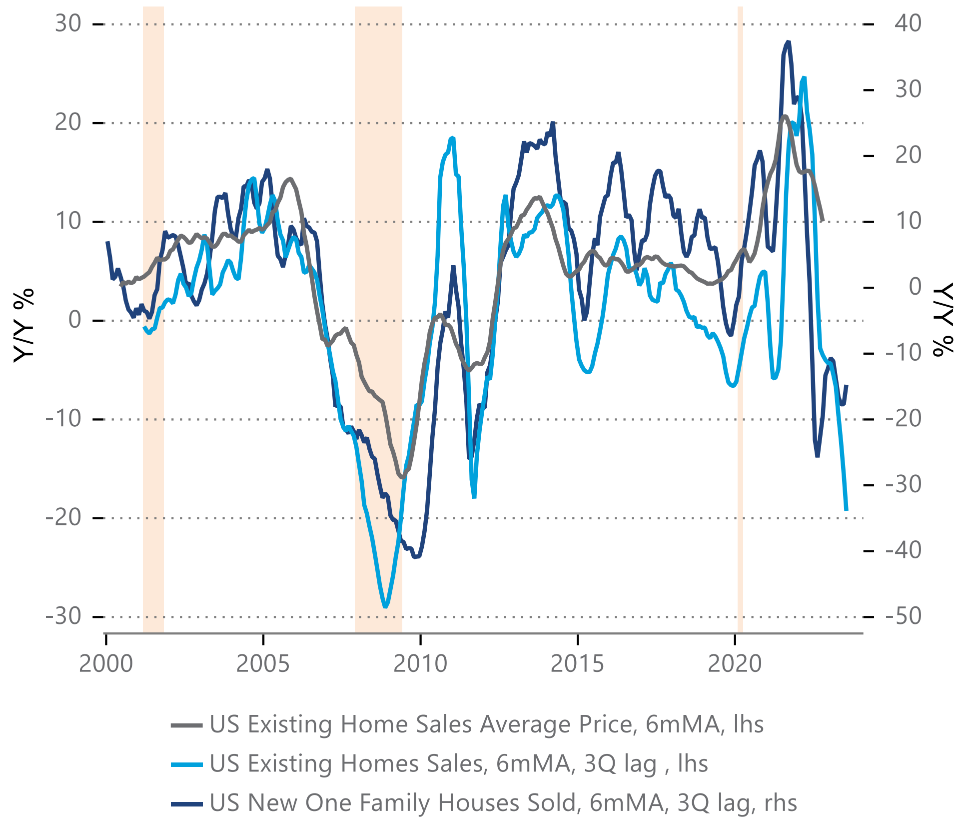
Ingredients for disinflation are here: Shelter

New lease inflation now slowing sharply

Source: Macrobond, MGI Economics, 15 December 2022

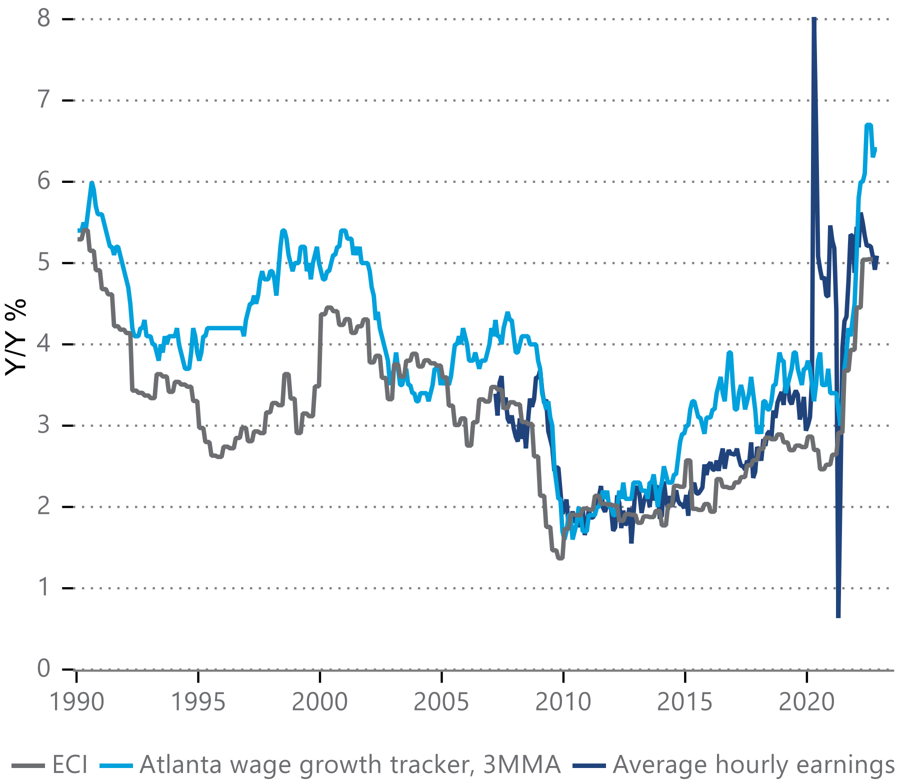
Activity suggests more to come



Source: Macrobond, MGI Economics, 15 December 2022

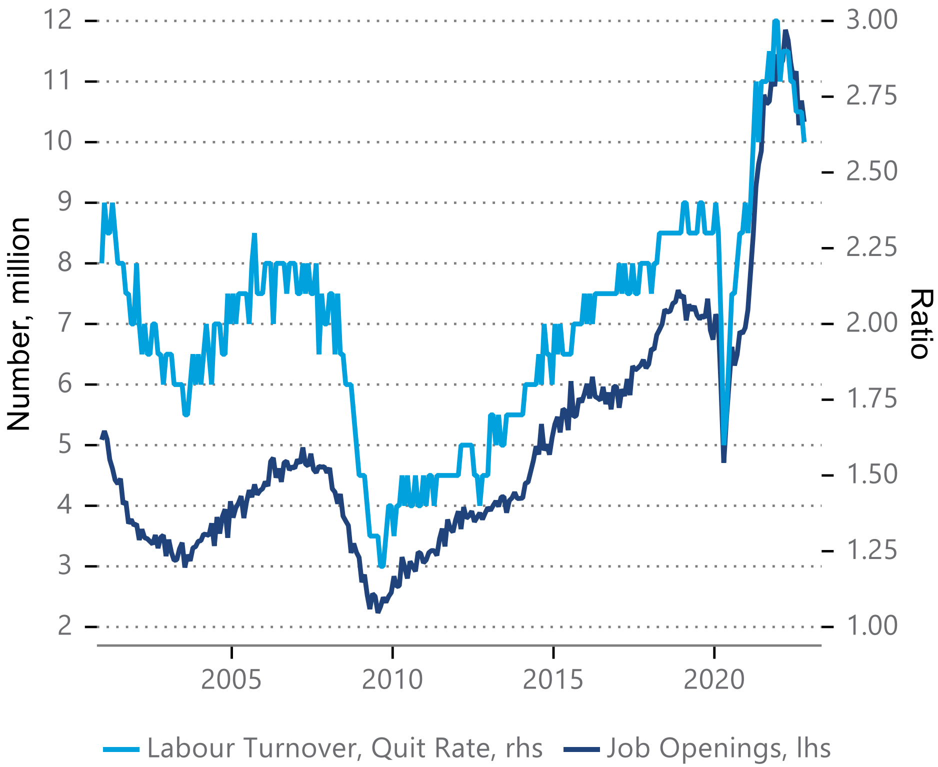
Ingredients for disinflation are here: Non-shelter services

Current wage growth still too high for 2% inflation



Source: Macrobond, MGI Economics, 15 December 2022

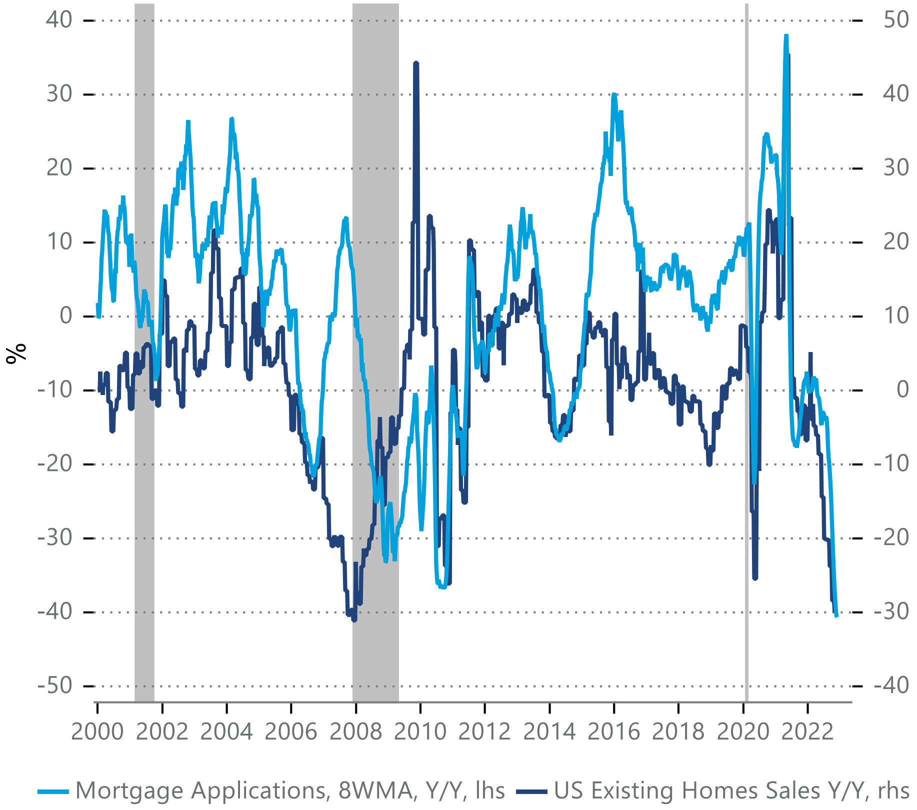
But some surveys show turning at margin



Source: Macrobond, MGI Economics, 15 December 2022

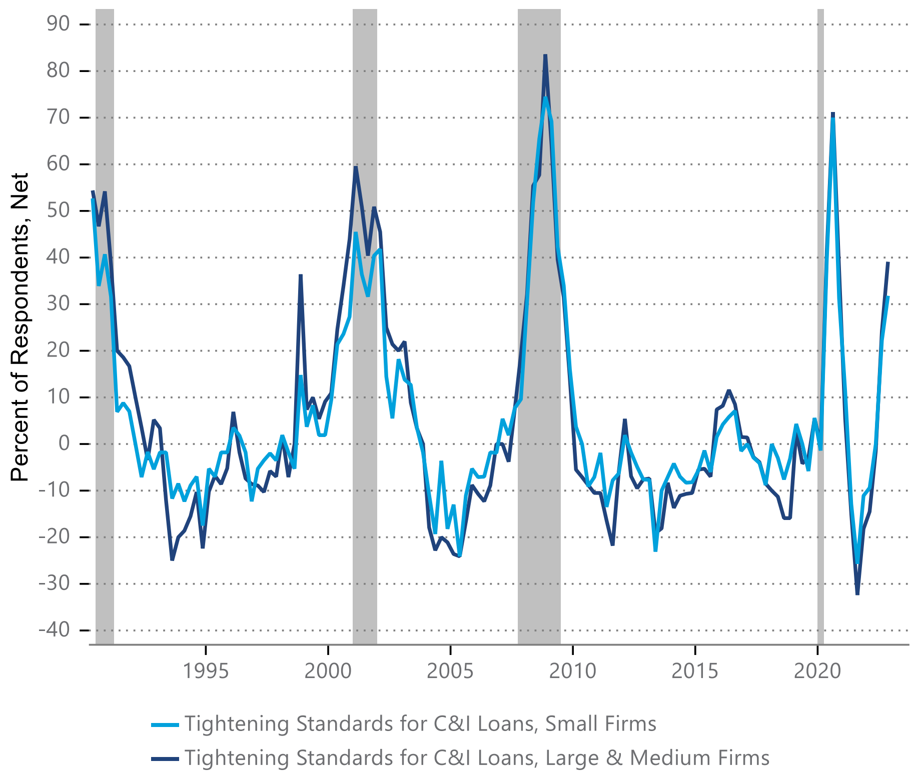
There are clear signs that tightening is hitting the economy

Housing activity weakens



Source: Macrobond, MGI Economics, 15 December 2022

Credit conditions tighten for firms



Source: Macrobond, MGI Economics, 15 December 2022

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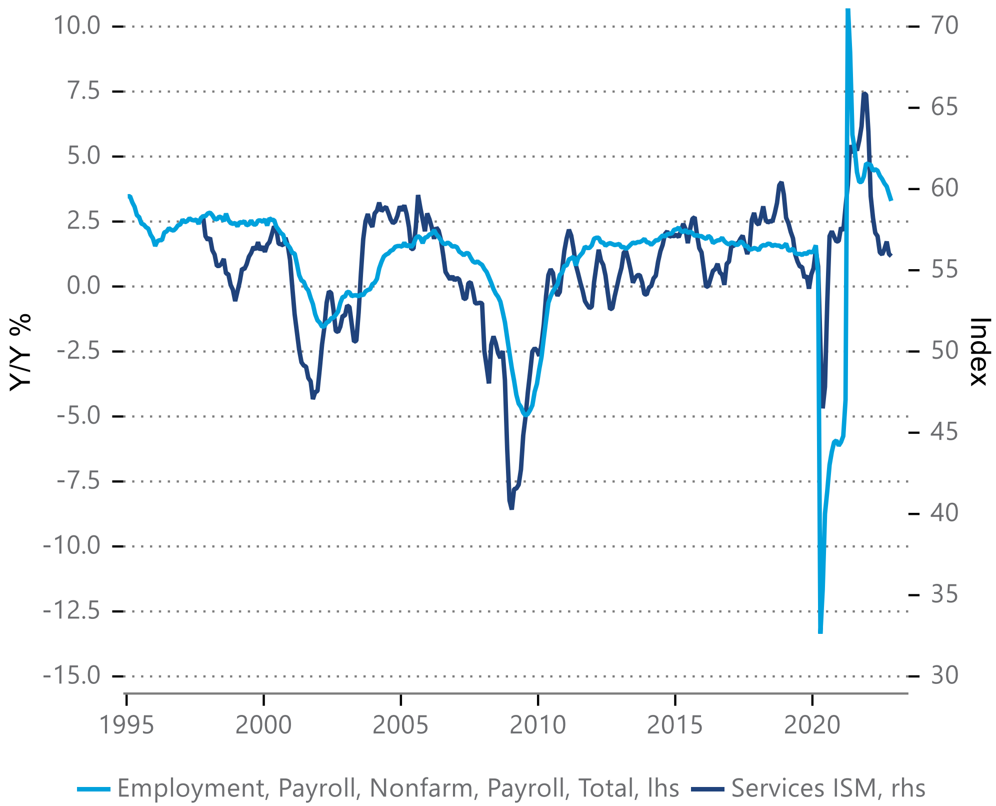
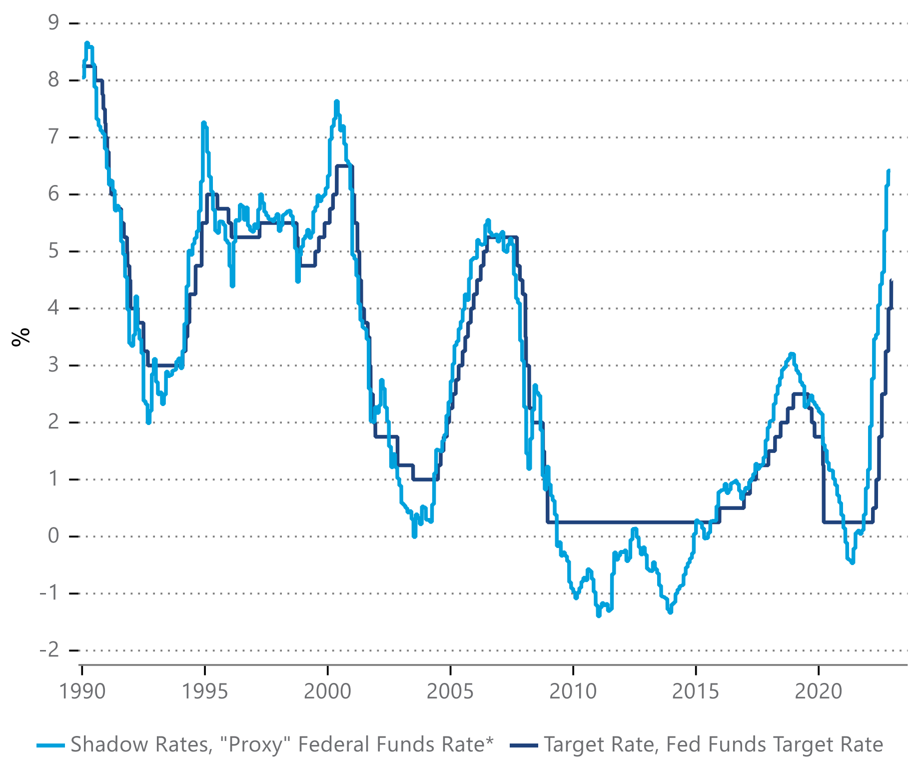
Federal Reserve makes important shift to forecast driven policy making

Labour market a lagging indicator of activity



Source: Macrobond, MGI Economics, 15 December 2022

Fed funds not only policy tool this time around

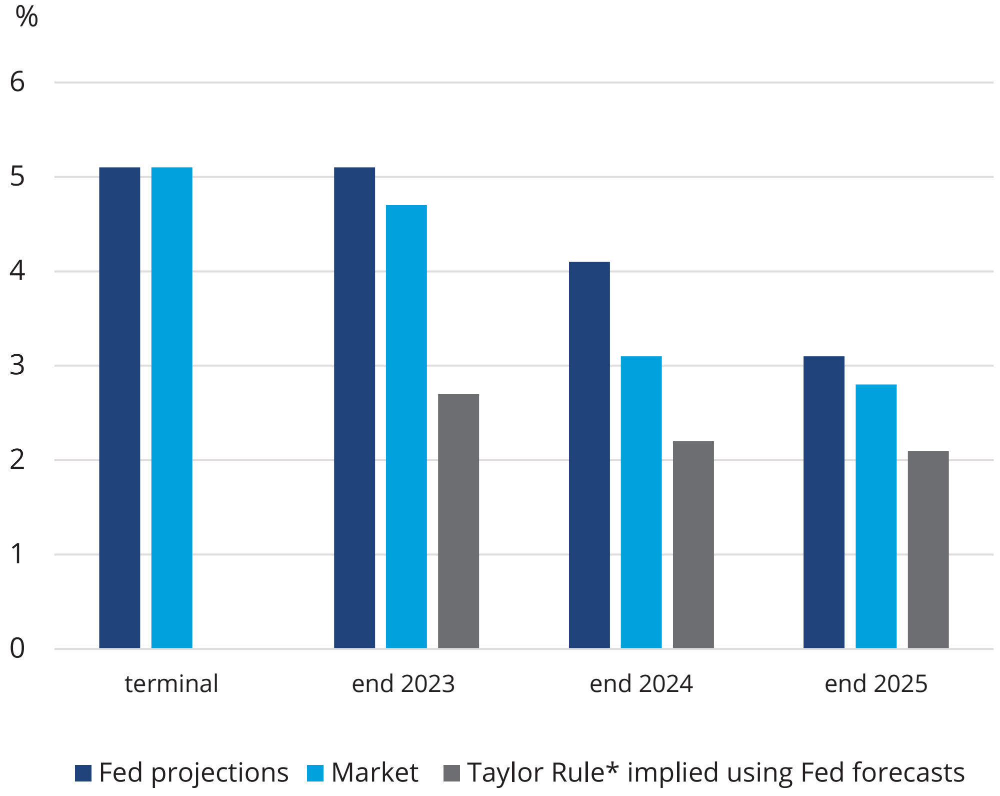


Source: Macrobond, MGI Economics, 15 December 2022

*The proxy rate indicates federal funds rate typically associated with prevailing financial market conditions if these conditions were driven solely by the funds rate

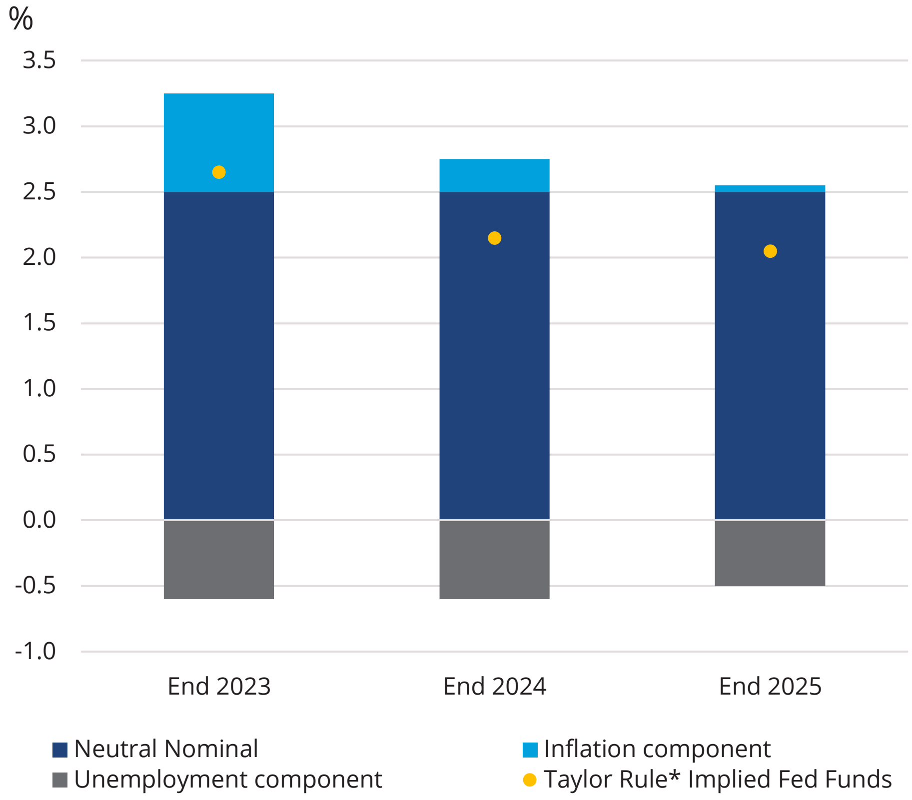
This implies Fed rhetoric not to be taken at face value

Fed's own forecasts imply a deeper cutting cycle vs market



Source: Macrobond, Bloomberg, Federal Reserve, MGI Economics, 15 December 22

Breakdown of Taylor Rule based on Fed's outlook



Source: Federal Reserve, MGI Economics, 15 December 22

*Taylor Rule takes Fed projections, coefficient of 1 on unemployment and 0.5 to core PCE

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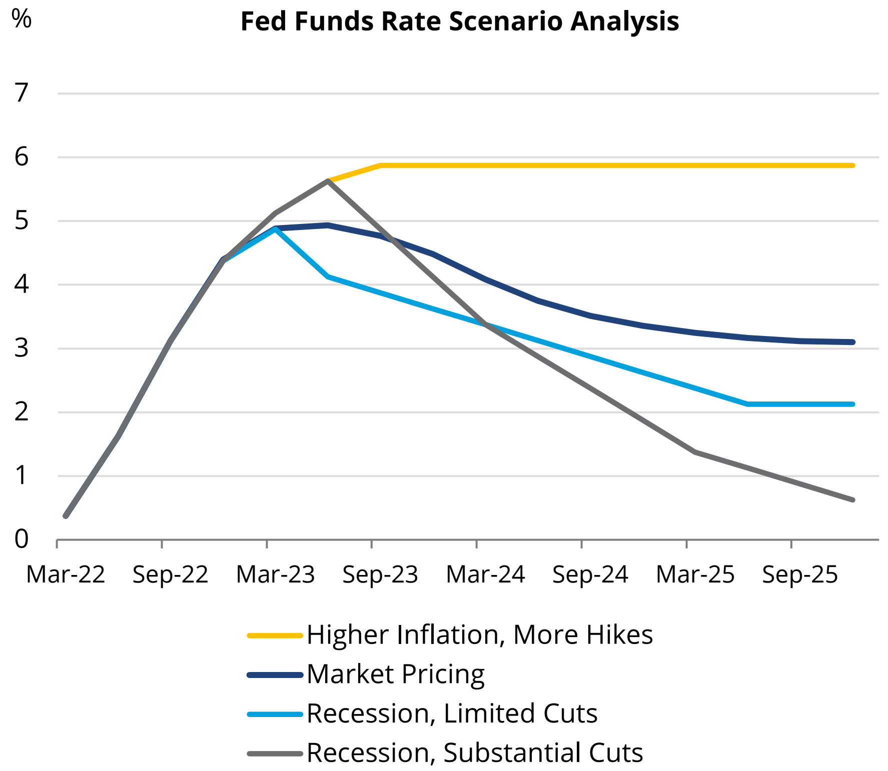
Driver of lower rates important for equities and wider risk markets

Pricing out of higher inflation scenario good for equity



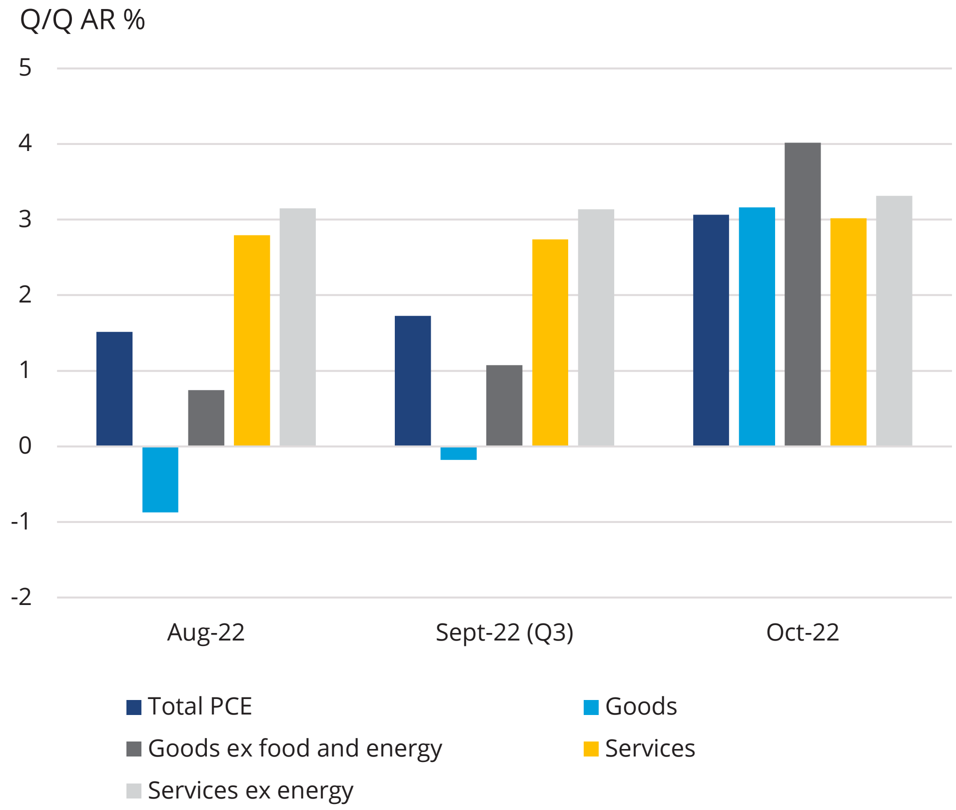
The above is stylised rate outlook under different scenarios.
Source: Goldman Sachs, MGI Economics, 11 December 2022

But medium term growth risks are negative

Source: Bloomberg, MGI Economics, 15 December 2022

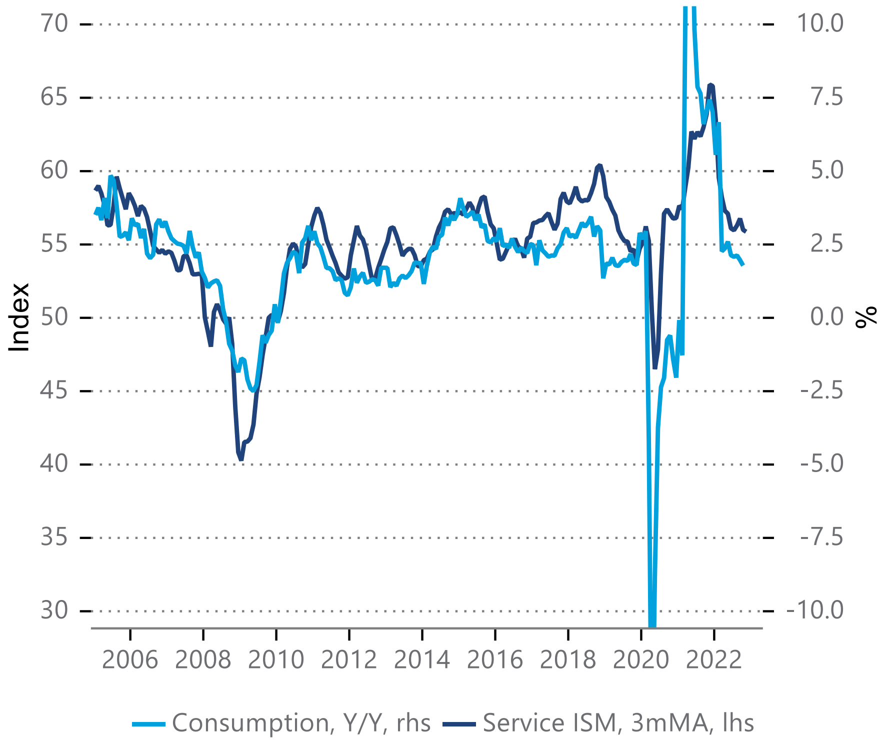
Surveys suggest consumption still has momentum

Consumption growth improved in October



Source: Bloomberg, MGI Economics, 15 December 2022

Surveys suggests momentum holding up



Source: Macrobond, MGI Economics, 15 December 2022

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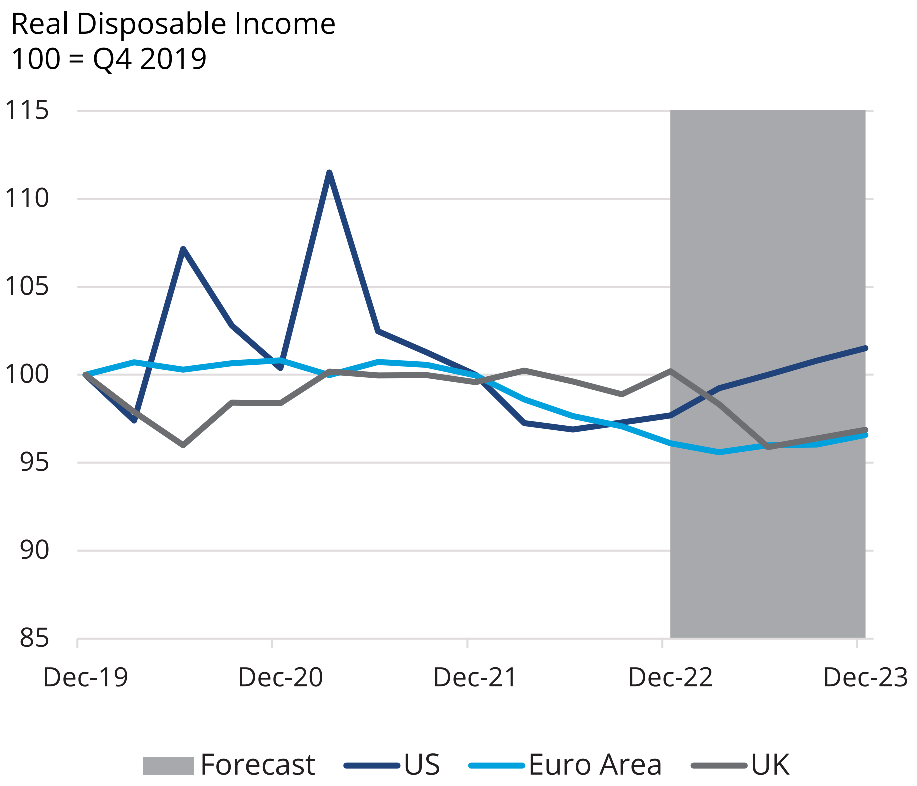
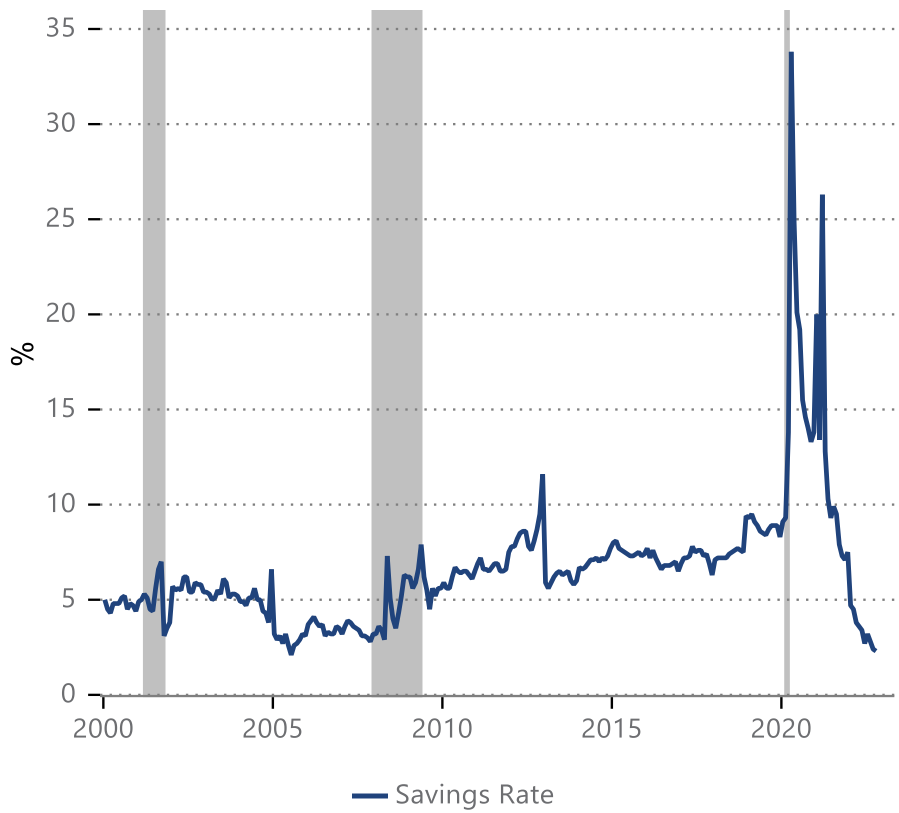
Households facing cross-currents but inflation major tailwind

Inflation a tailwind for consumer income



GS Forecast
Source: Goldman Sachs, MGI Economics, 15 December 2022

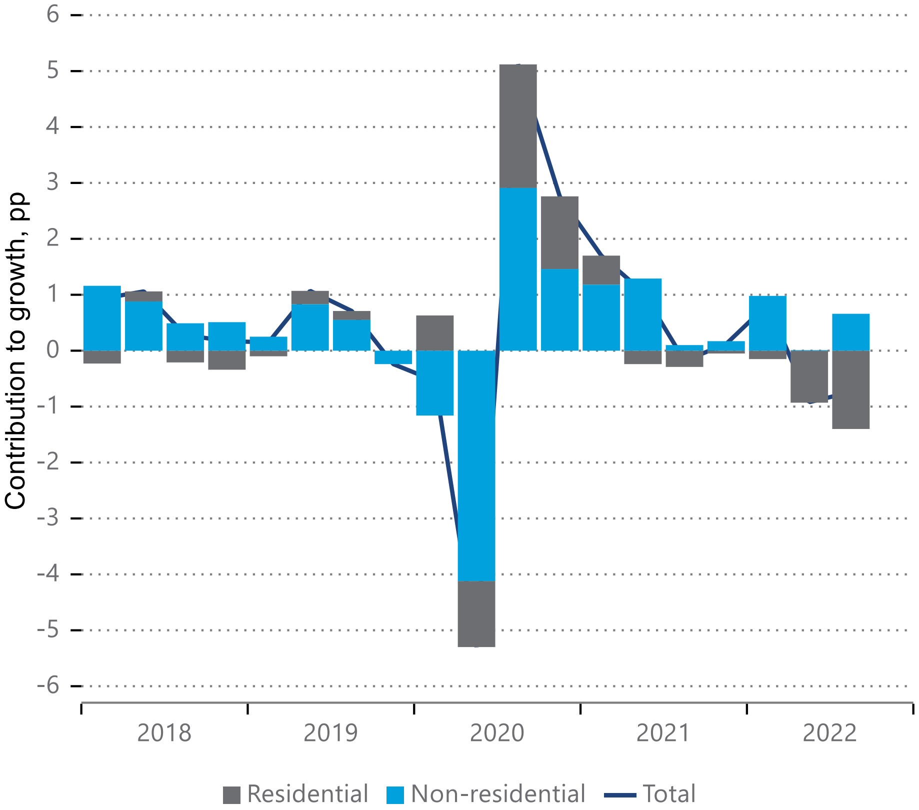
Savings rates close to record lows, with stock uneven



Source: Morgan Stanley, MGI Economics, 15 December 2022.

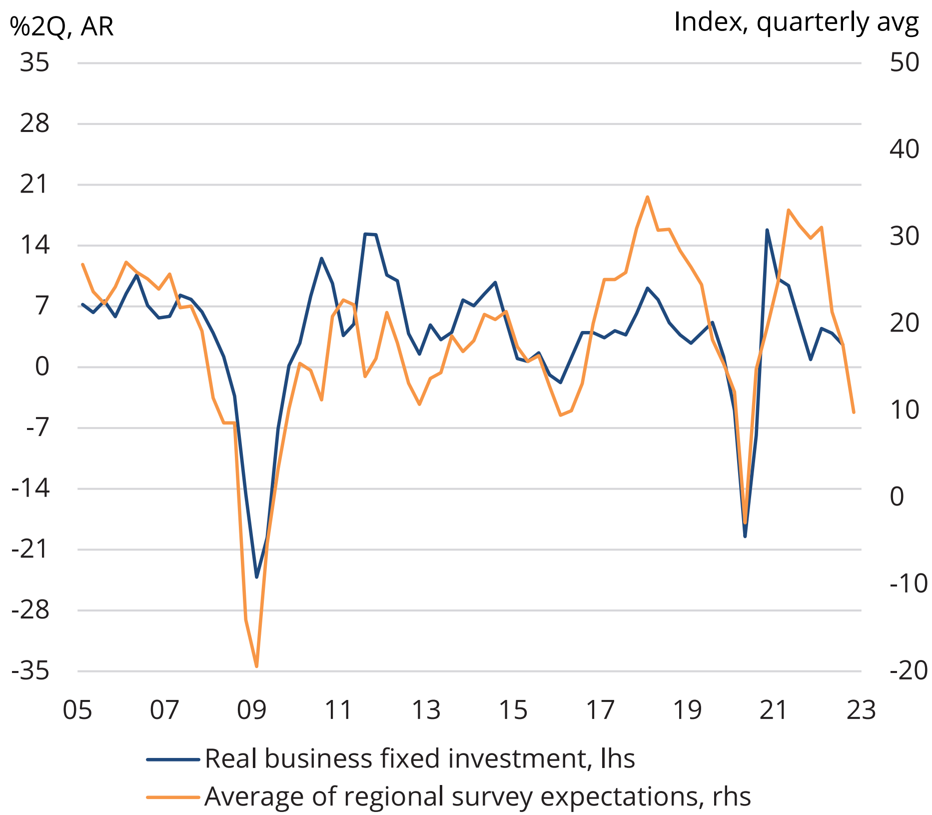
Meanwhile investment likely to slow

Residential investment likely to drag on growth further



Source: Macrobond, MGI Economics, 15 December 2022

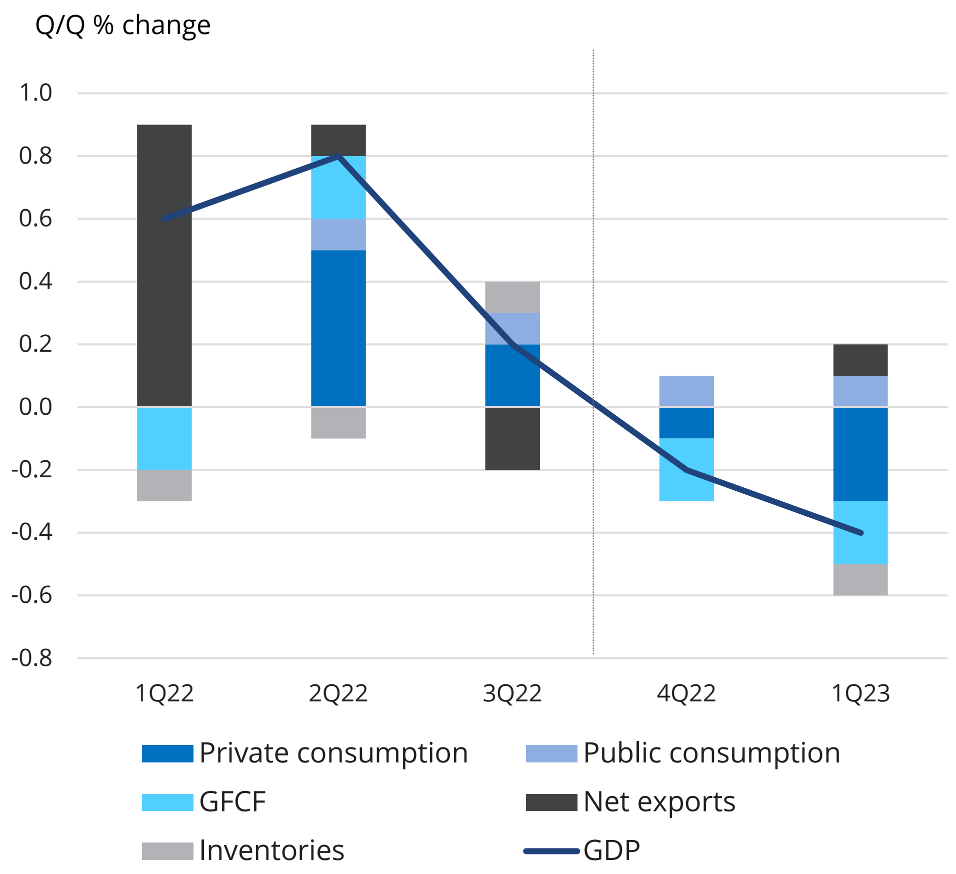
Business capex intentions fall



Source: JPM, Various Fed Branches, 15 December 2022.

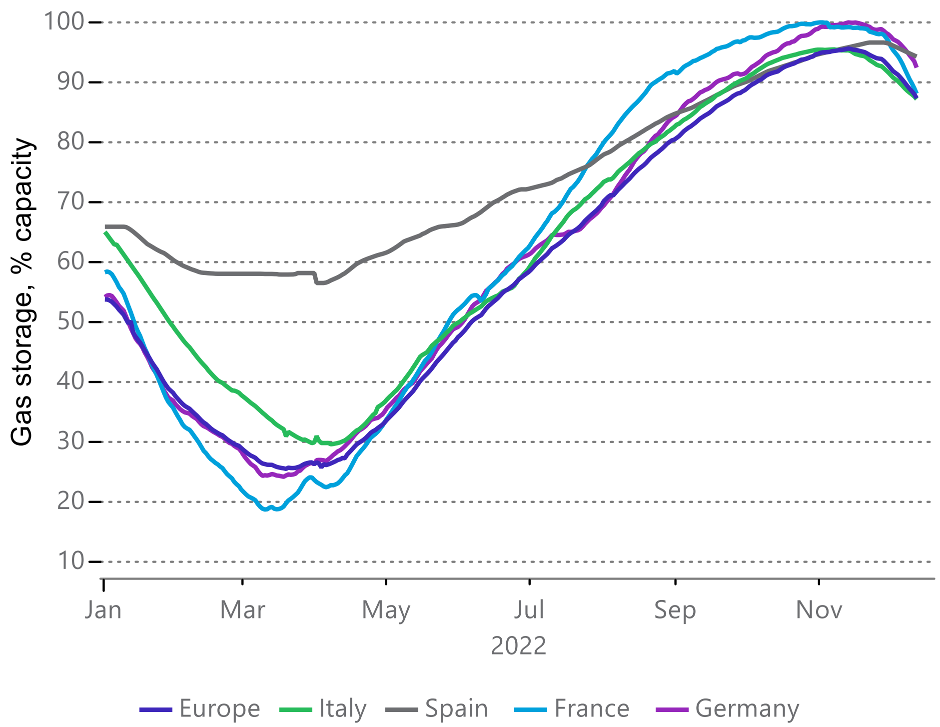
Recession likely too mild for ECB to stop hiking

Domestic demand likely to slow from here



Source: Morgan Stanley, MGI Economics, 13 December 2022

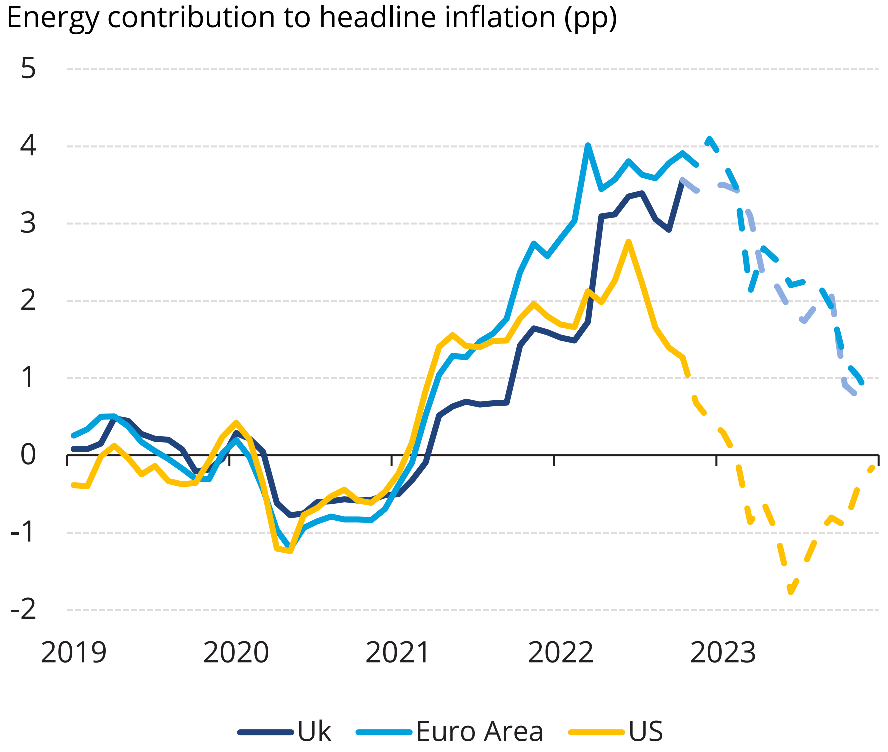
Exceptionally warm weather slows gas storage draw-down



Source: Macrobond, MGI Economics, 13 December 2022

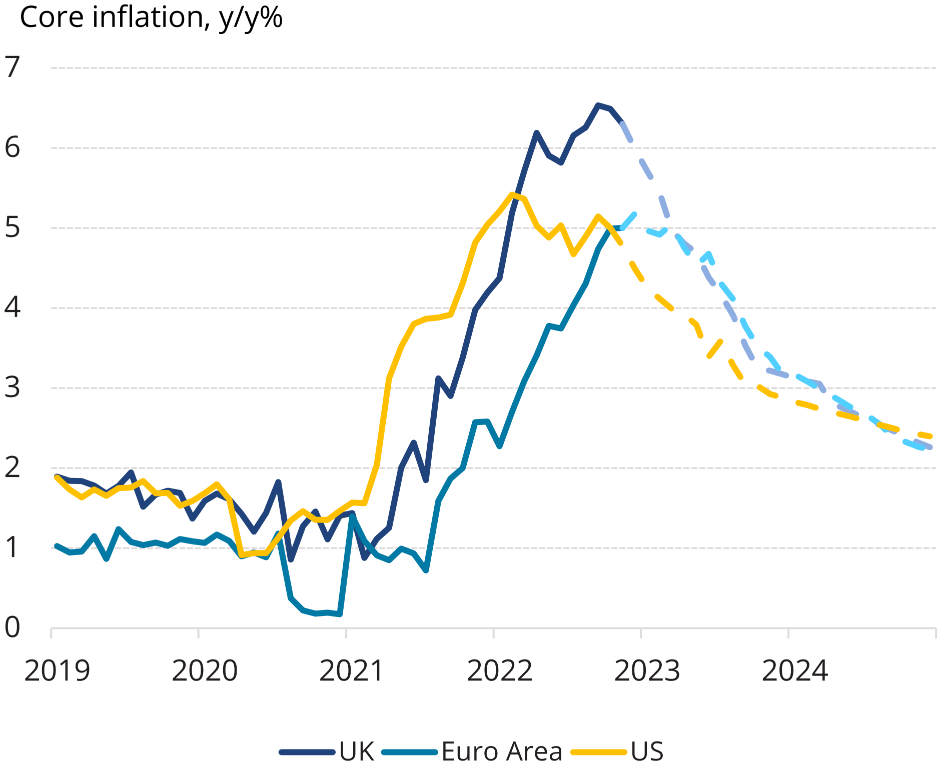
European disinflation likely to lag the United States

Energy likely to keep inflation



Dashed line is Goldman Sachs forecast.
Source: Goldman Sachs, MGI Economics, 14 December 2022

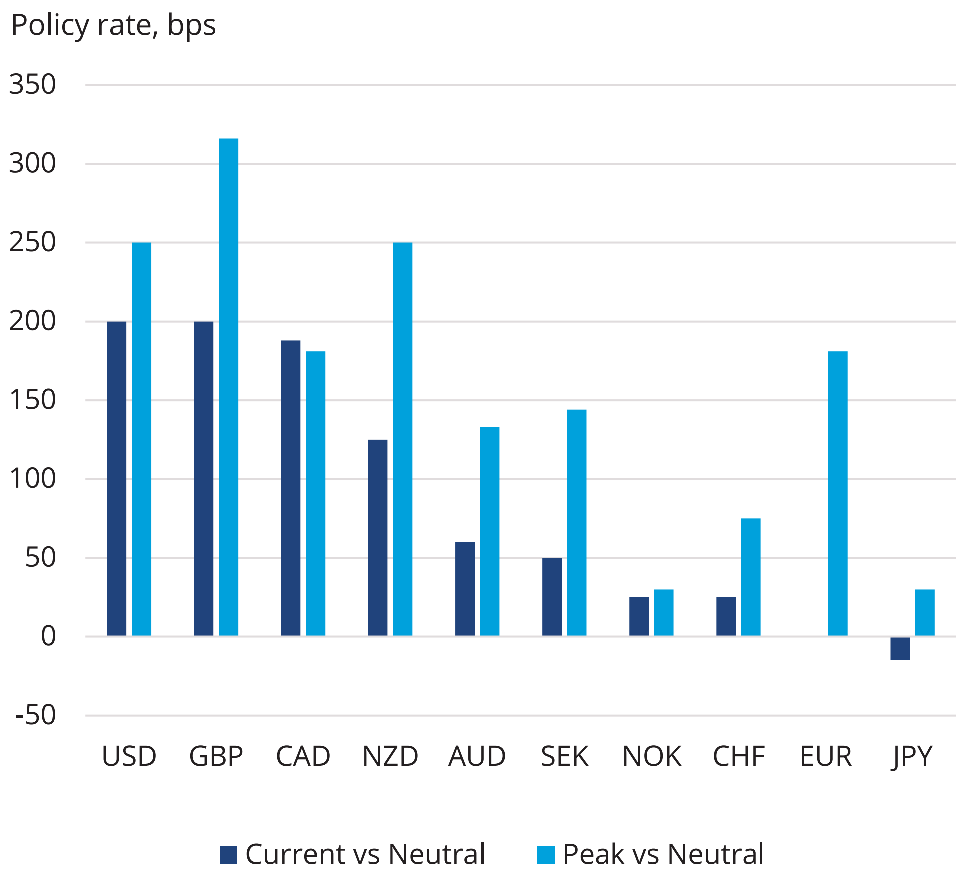
Falling headline inflation a tailwind for the US consumer



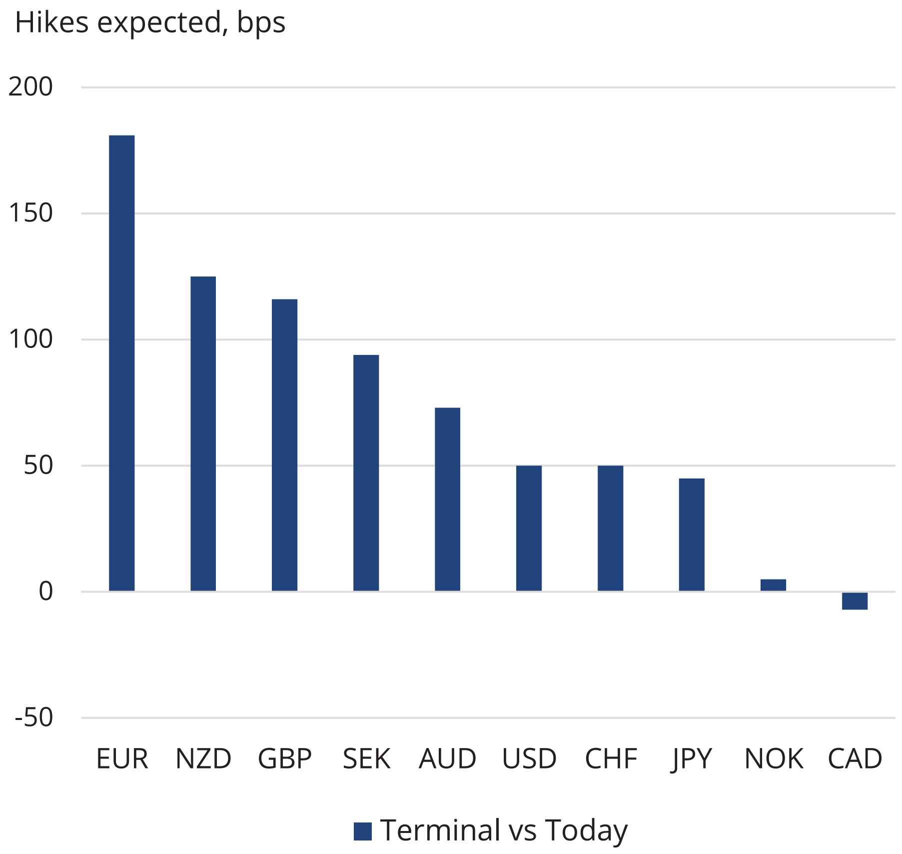
Dashed line is Goldman Sachs forecast.
Source: Goldman Sachs, MGI Economics, 14 December 2022

ECB still has some catching up to do

ECB only just reaches neutral



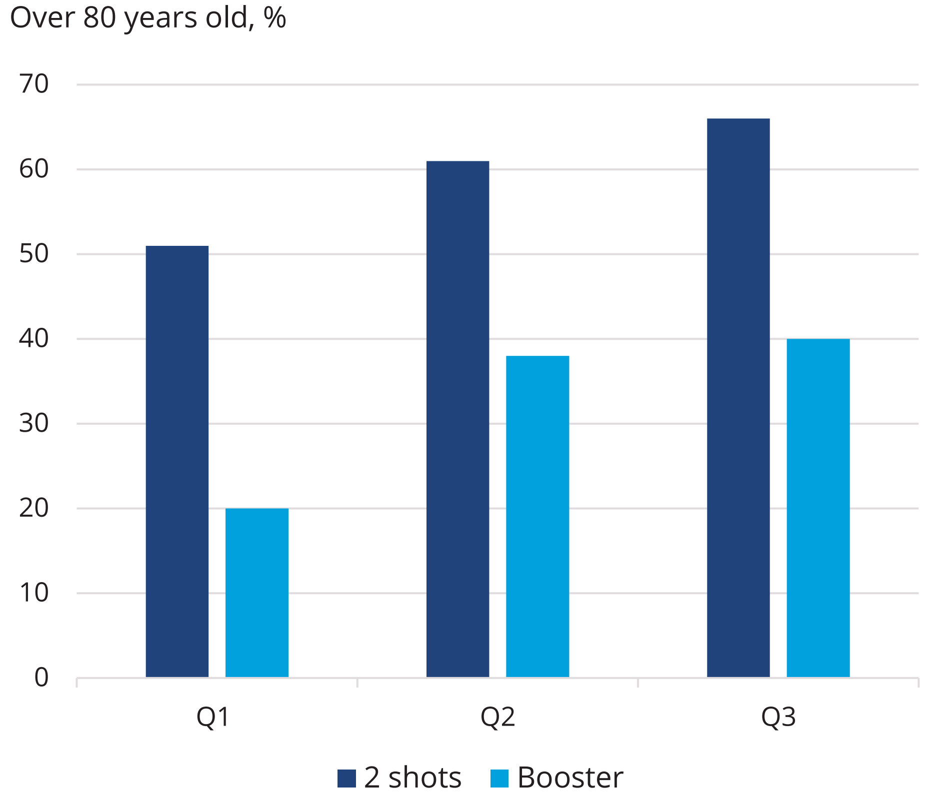
Europe likely to be hawkish for longer



Today, as of 15 December 2022. Source: Bloomberg, Goldman Sachs (estimate of neutral rate), MGI Economics, 15 December 2022

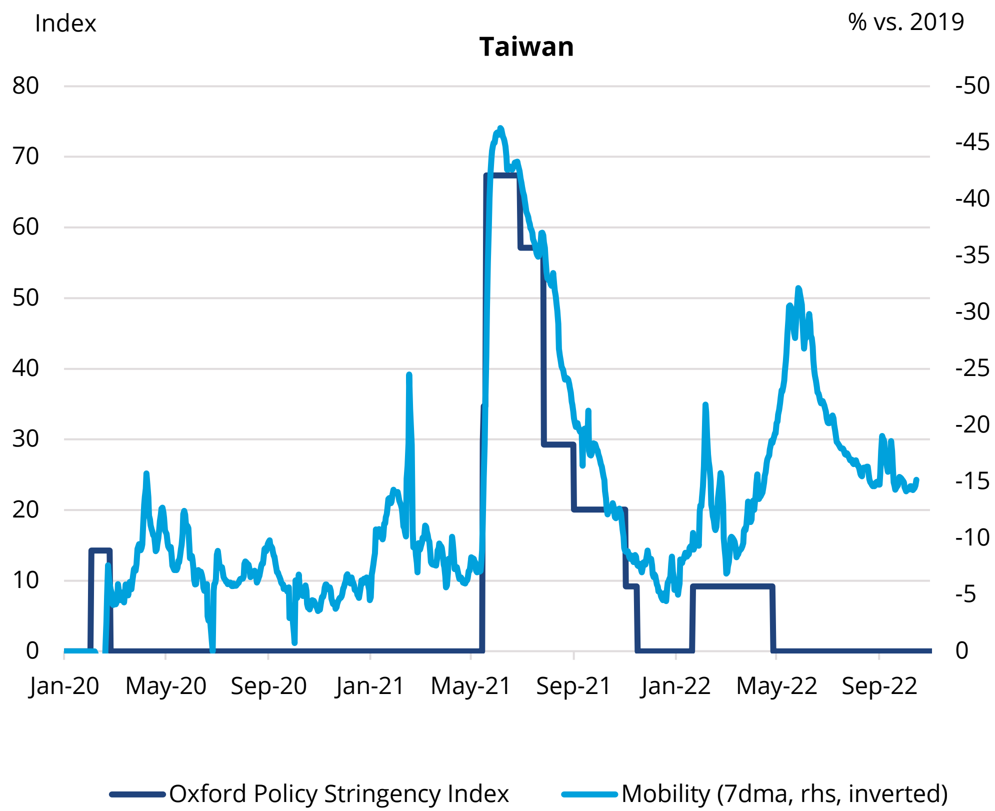
China prepares to reopen but fundamentals point to speed limit

Elderly vaccination rate is still low



Source: UBS, MGI Economics, 9 December 2022

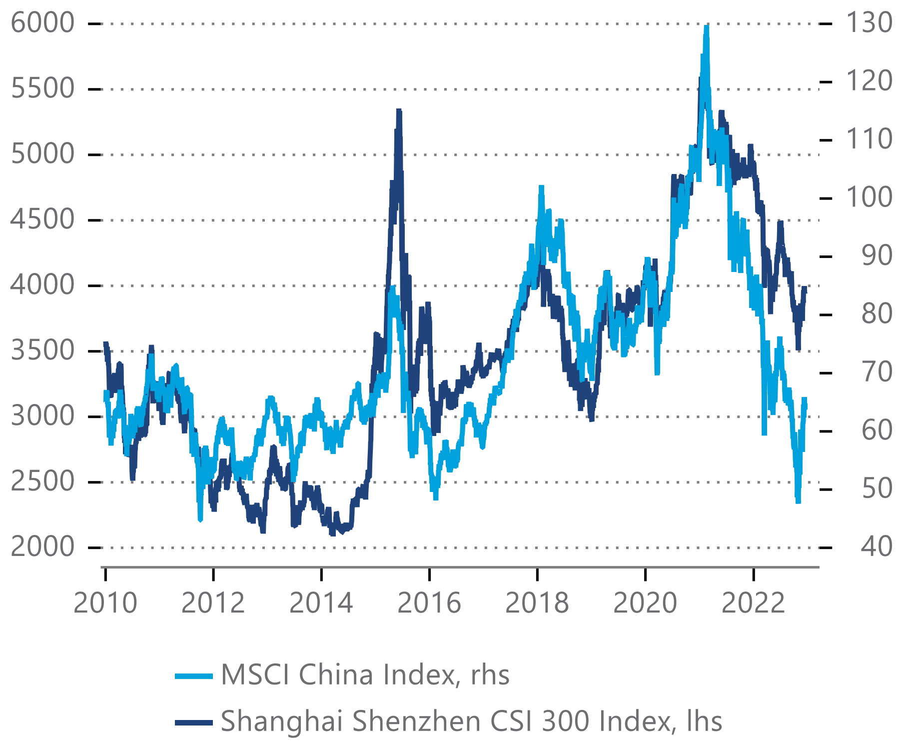
Comparators show exit wave and mobility decline



Source: Goldman Sachs, MGI Economics, 11 December 2022

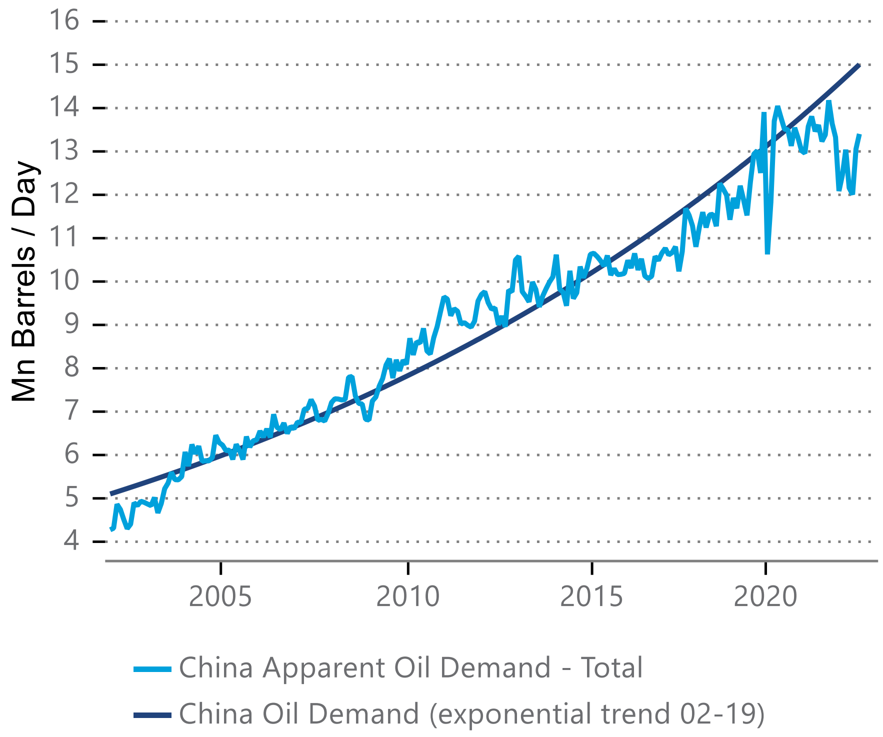
Gradualism boosts sentiment more than energy demand

Chinese equities have risen but still at low levels



Source: Bloomberg, Macrobond, MGI Economics, 9 December 22

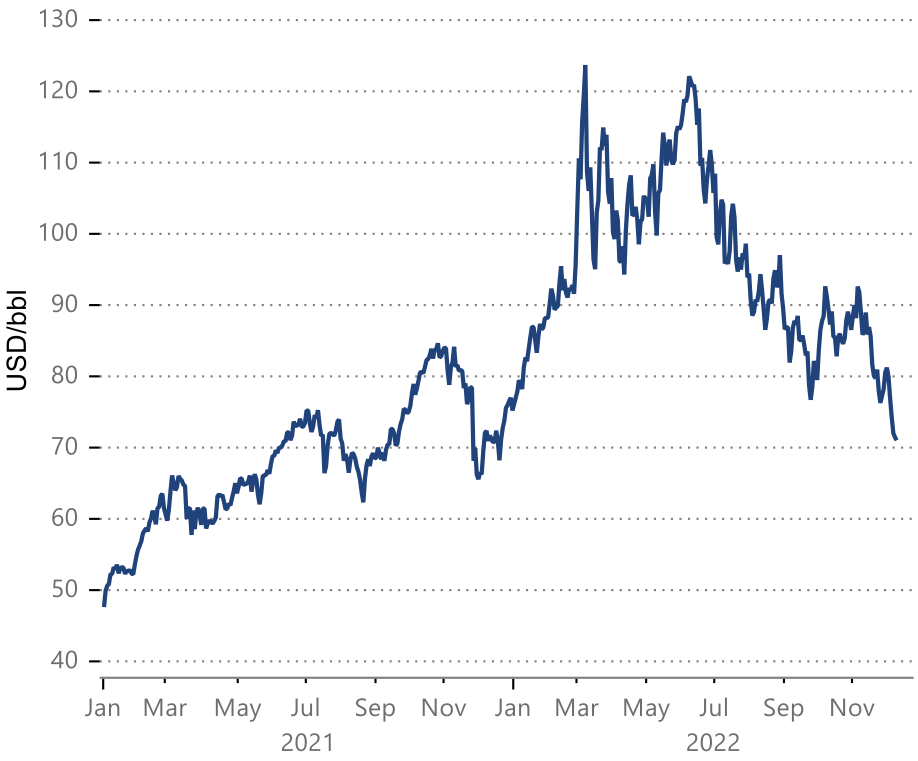
China oil demand is 2mb/d lower than pre-covid trend



Source: Macrobond, Morgan Stanley, MGI Economics, 9 December 22

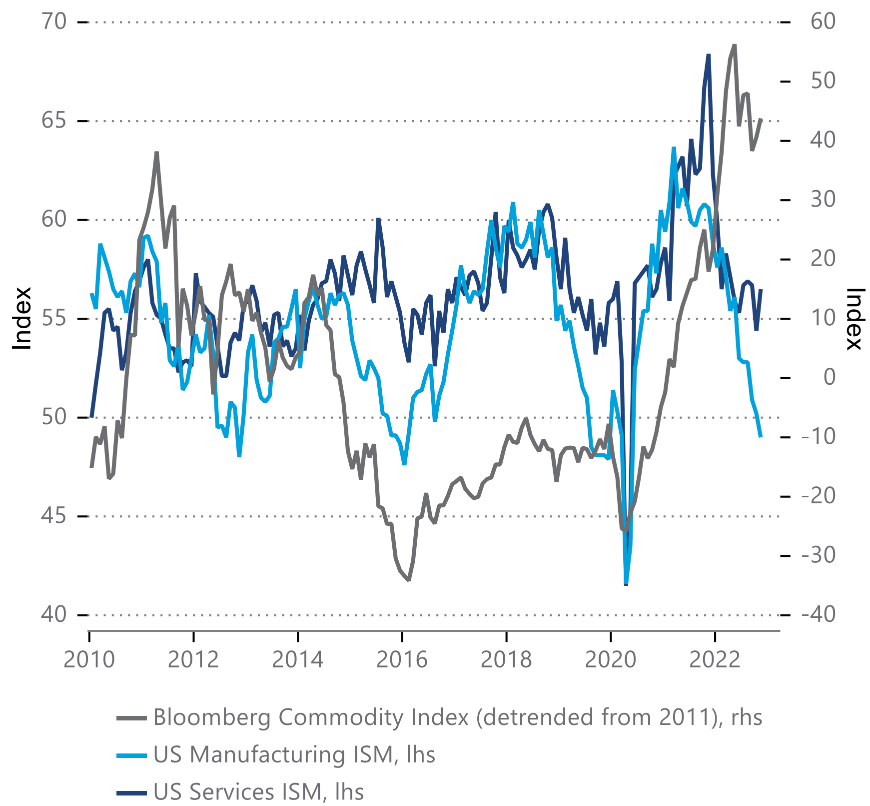
Leaving oil prices likely stable to lower

Oil prices have fallen in face of supply concerns



Source: Bloomberg, Macrobond, MGI Economics, 9 December 2022

Global demand a headwind to commodity prices



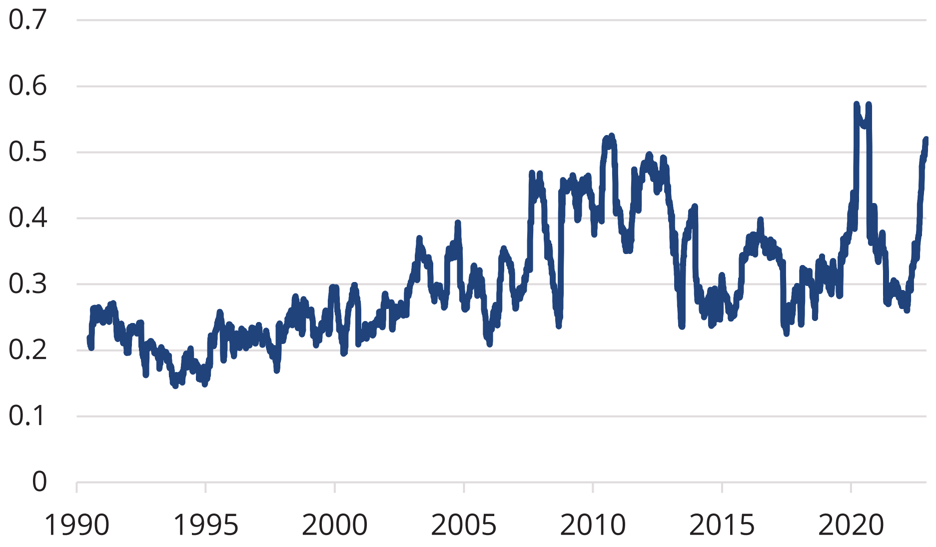
Source: Bloomberg, Macrobond, MGI Economics, 9 December 2022

CURRENCY VIEWS

USD (-) Inflation is still dominant theme in a top-down market

We are in a risk on/ risk off (RORO) world

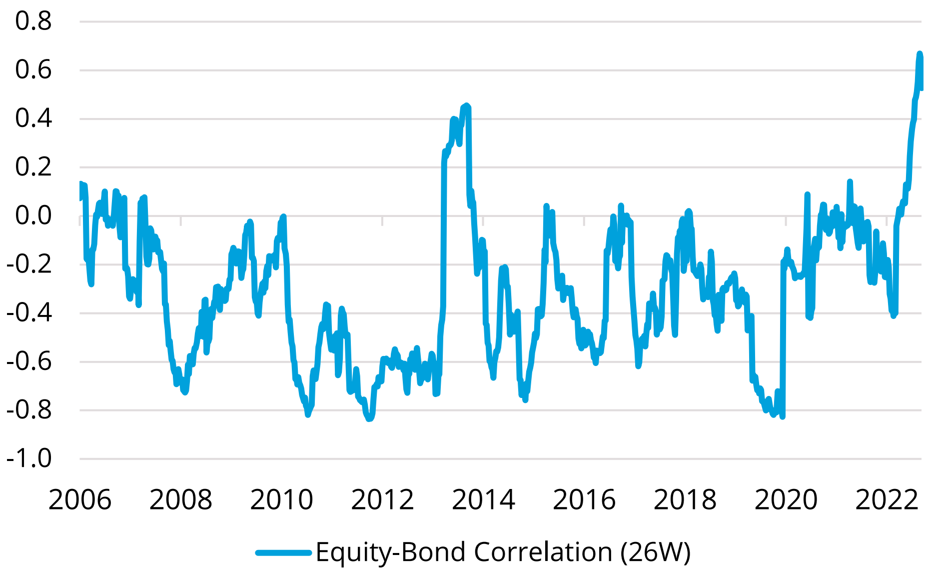
Correlation across (multi) asset class
HSBC RORO Indicator



6M Correlation. Source: HSBC, MGI Economics, 14 December 2022

Equity-bond correlations show inflation

Correlation Coefficient



Source: HSBC, MGI Economics, 13 December 2022

Our currency views are broadly based on a simple observation about what is driving financial markets. Correlation across asset classes is historically extremely high and the equity-bond correlation is very positive. This tells us we are in a "top-down" world, where inflation is the main driver of directionality. This points to the global inflation outlook being particularly important and bottom-up idiosyncratic stories less so important. For us, while we accept the US inflation outlook is partially priced in bond markets (see slide 12), our views on inflation suggests 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.

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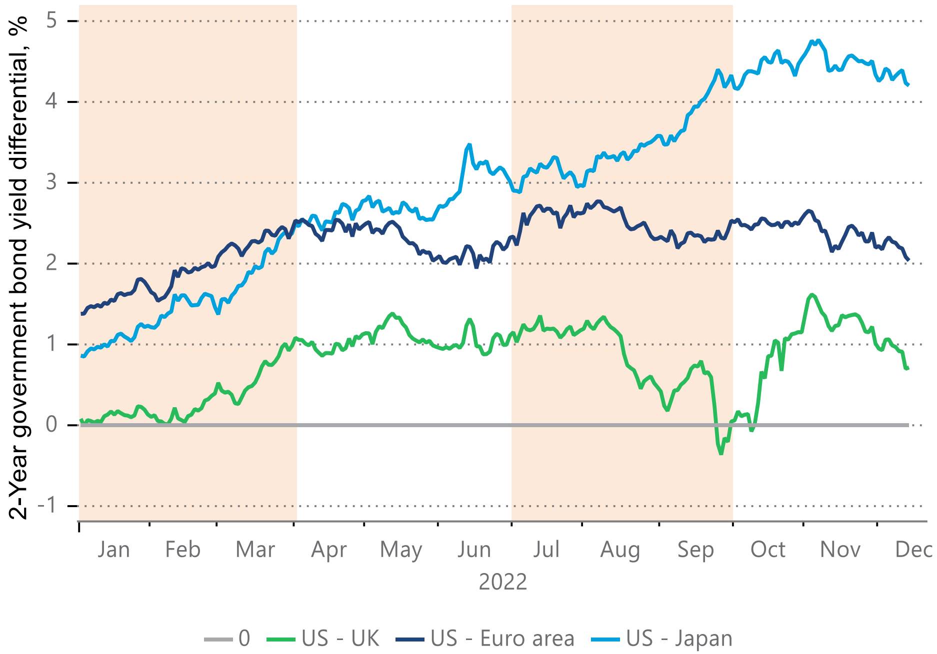
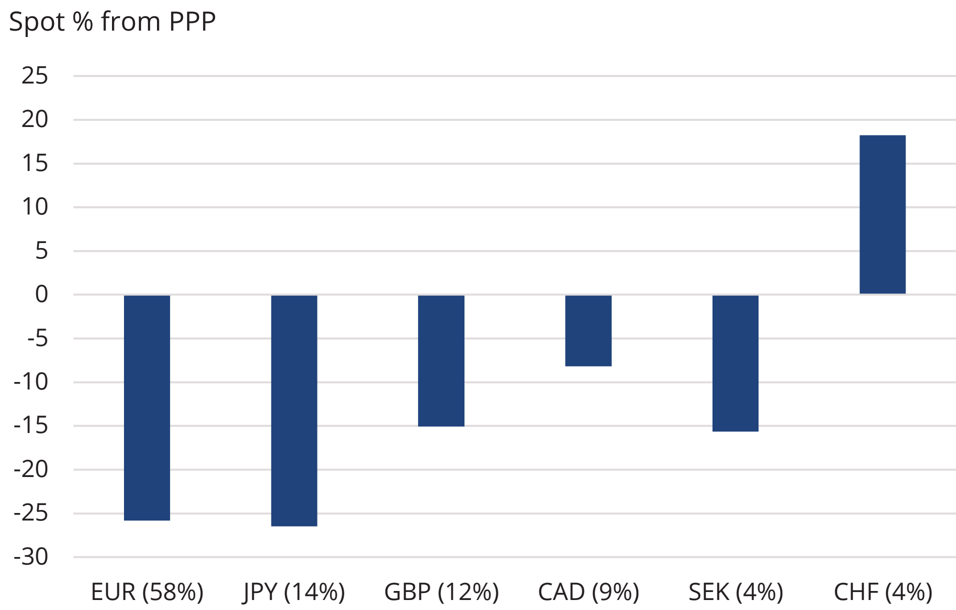
USD (-) DXY still expensive as yield differential support reverses

Yield differentials move against the dollar



Source: Macrobond, MGI Economics, 14 December 2022

DXY is still overvalued



Weight in DXY in parenthesis.
Source: Macrobond, MGI Economics, 14 December 2022

While the dollar has weakened, it still remains expensive, particularly through the lens of the DXY 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. Our view remains reasonably tactical – the US is on track for a mild recession with a Federal Reserve that has signalled an unwillingness to cut interest rates. However, we see “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.

EUR (+) Energy shock to take a smaller than expected toll on growth

Hard data has outperformed surveys

Source: Macrobond, MGI Economics, 12 December 2022

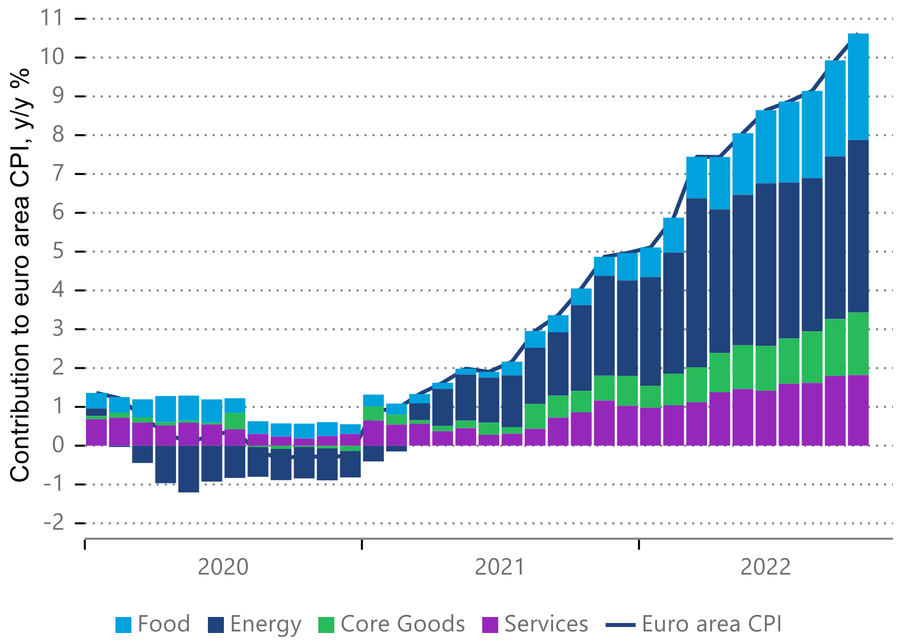
While natural gas prices should fall in Q1 2023

Source: Goldman Sachs, MGI Economics, 13 December 2022

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.

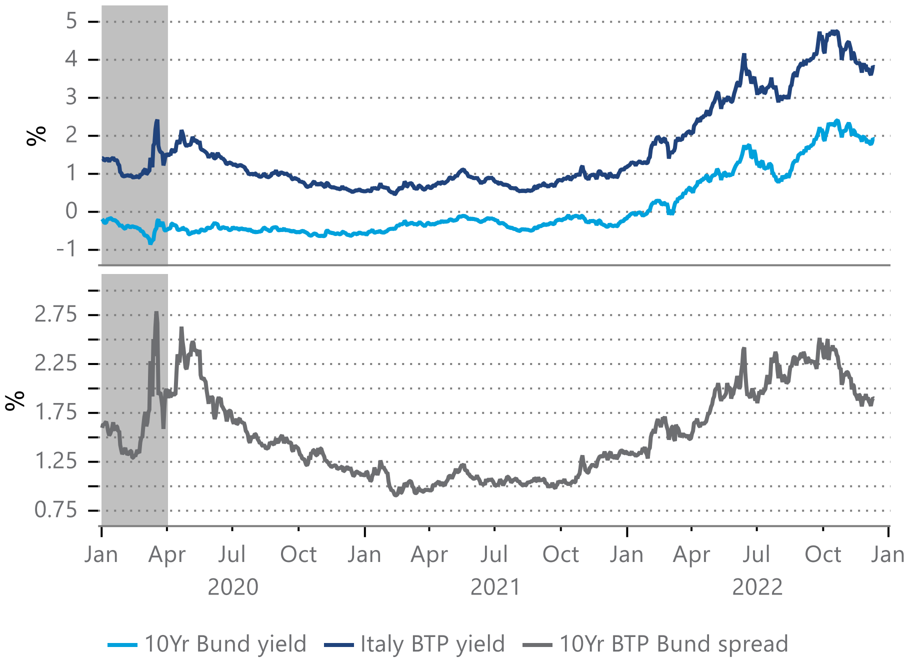
EUR (+) ECB to remain hawkish despite recession

ECB hikes in pipeline as inflation remains elevated



Source: Macrobond, MGI Economics, 12 December 2022

Italian sovereign spread risks contained



Source: Macrobond, MGI Economics, 12 December 2022

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. In our view, 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.

MILLENNIUM GLOBAL

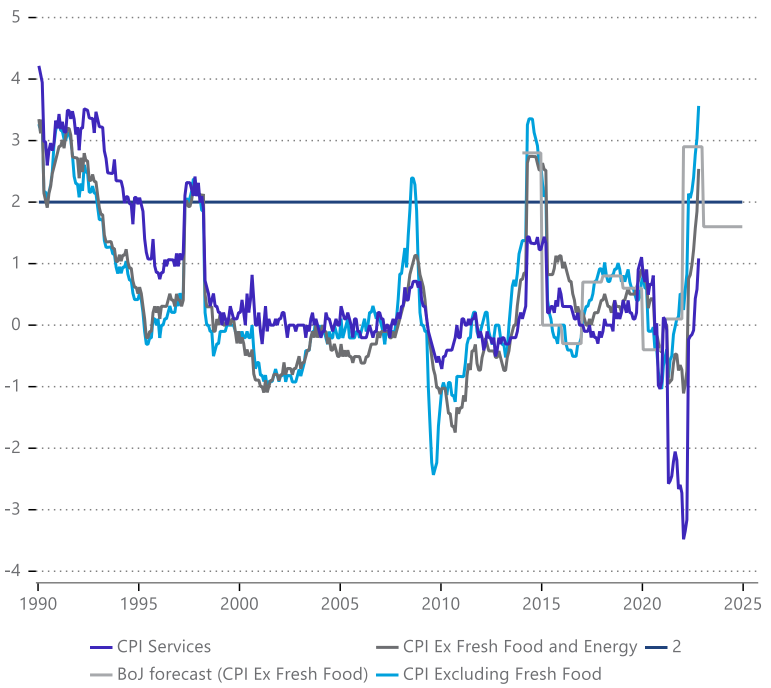
JPY (+) A valuation opportunity with good risk-reward

Yen does well in range of economic scenarios

Scenario	Scenario description	JPMorgan probability assessment
1	Fed has already overtightened, near term global recession	20%
2	Growth slows and US slips into recession late 2023	32%
3	Inflation has not peaked, Fed hiking resumes in H2 23	28%
4	Soft landing	20%

Source: JP.Morgan Global Economics, 9 November 2022

Forecasts show the BoJ have more belief in inflation target



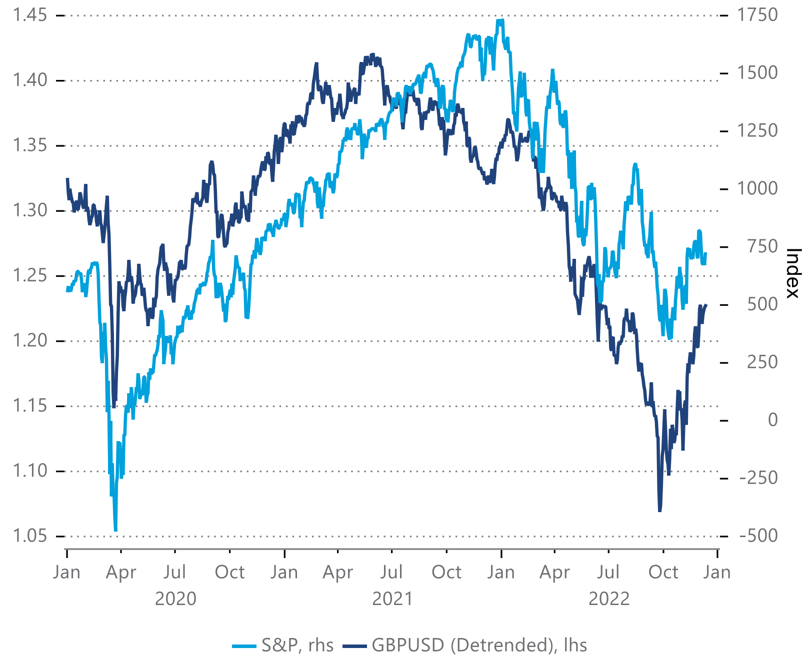
Source: Bloomberg, MGI Economics, 13 December 2022

Despite its recent appreciation, the yen is still the cheapest currency in G10 (see slide 36). Given the main driver of the yen continues to be relative yield differentials, our view that US inflation and growth are likely to slow over the next quarter points to treasury yields moving lower. We also acknowledge the broad uncertainty in the economic outlook but see good risk-reward for the yen given the economic scenarios (see chart above). While our view is premised on the US side of equation, we think the explicit forecasting of a "virtuous" inflation cycle from the Bank of Japan ("BoJ") is meaningful and though we do not see a change in yield curve control from the Bank of Japan next quarter, we expect Japanese inflation developments to generally support a normalisation in policy in the second half of the year.

MILLENNIUM GLOBAL

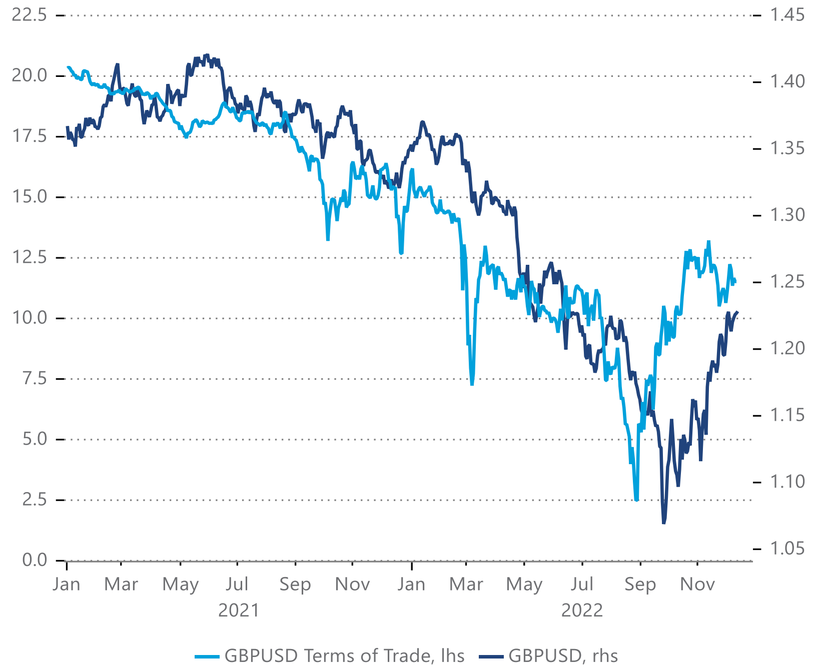
GBP (0) Benefits from supportive risk backdrop as US inflation falls

Sterling has been boosted by the recent equity rally



Source: Macrobond, MGI Economics, 13 December 2022

In context of lower energy prices



Source: Macrobond, MGI Economics, 13 December 2022

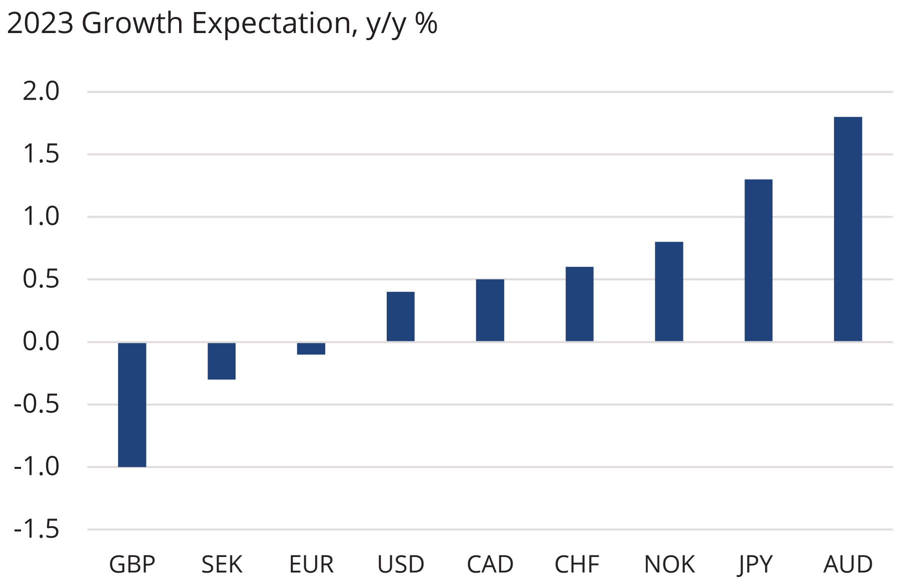
Sterling has benefitted from the broad turn in risk sentiment and in particular, the FX correlation with US equities. Our view that US inflation is likely to fall over the quarter should continue to support GBP from a yield differential and risk-sentiment point of view (as US yields move lower and equity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

GBP (0) But UK cyclical and structural vulnerabilities remain

Wage growth should keep the Bank of England hawkish

Source: Macrobond, MGI Economics, 14 December

UK growth prospects worst in G10 next year



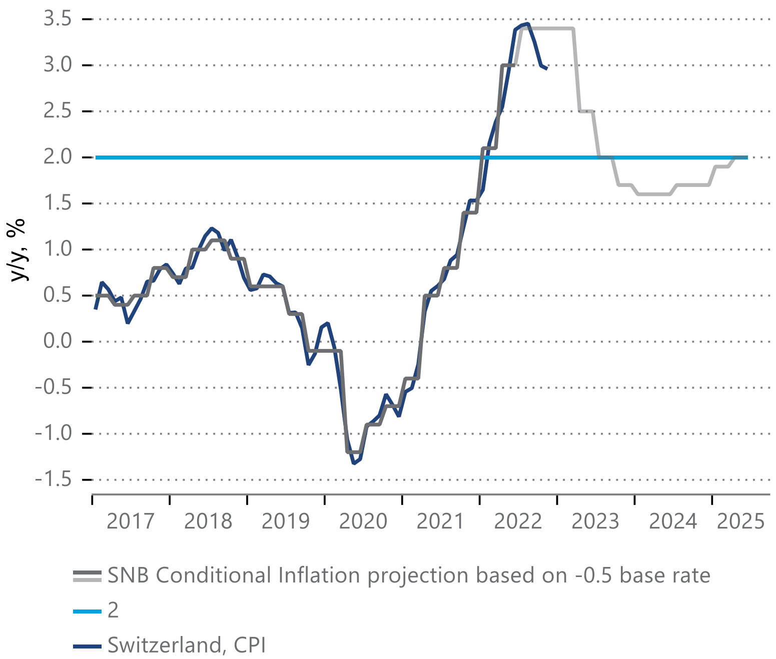
Source: Bloomberg Consensus, 13 December 2022

Our bottom-up view is less supportive of sterling. Firstly, we expect UK growth 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. On the whole, we think the top-down story is likely to overwhelm but aware of there is lack of UK domestic impulse.

MILLENNIUM GLOBAL

CHF (0) SNB normalisation almost complete

SNB forecasts suggest not much more to do



Source: SNB, 15 December 2022

CHF strengthened through gas crisis

Source: Macrobond, MGI Economics, 15 December 2022

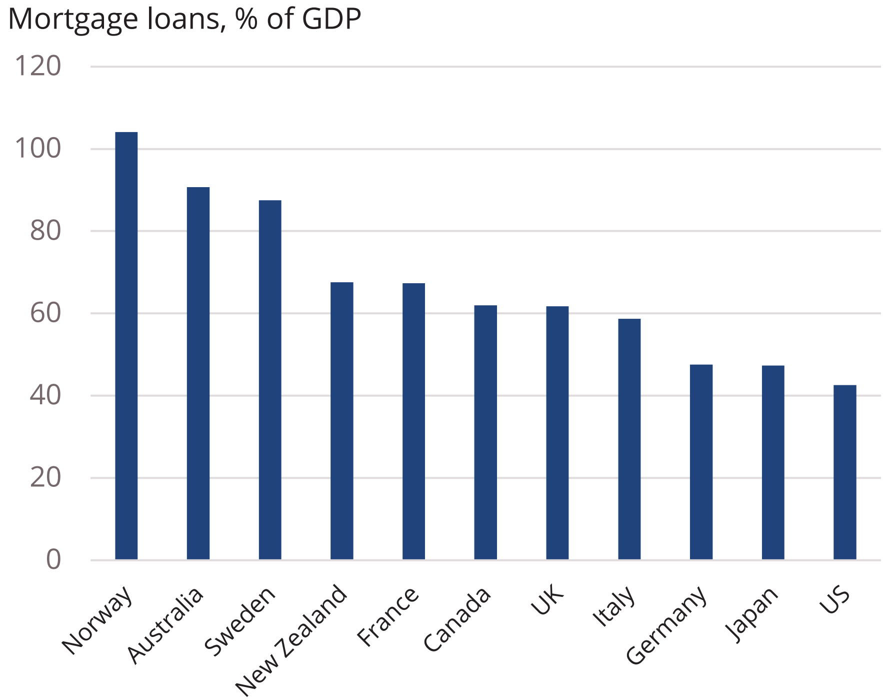
From a cyclical point of view, the relatively low inflation and wage backdrop suggest the Swiss National Bank (SNB) are nearly done with their hiking cycle, leaving the central bank to focus on monetary policy implementation. We therefore take a slightly more dovish view than the market, which leaves us 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.

AUD (0) Mixed equity environment with dovish risk to RBA

AUDUSD broadly a view on equity risk

Source: Macrobond, MGI Economics, 12 December 2022

RBA faces an interest sensitive economy



Source: Goldman Sachs, MGI Economics, 12 December 2022

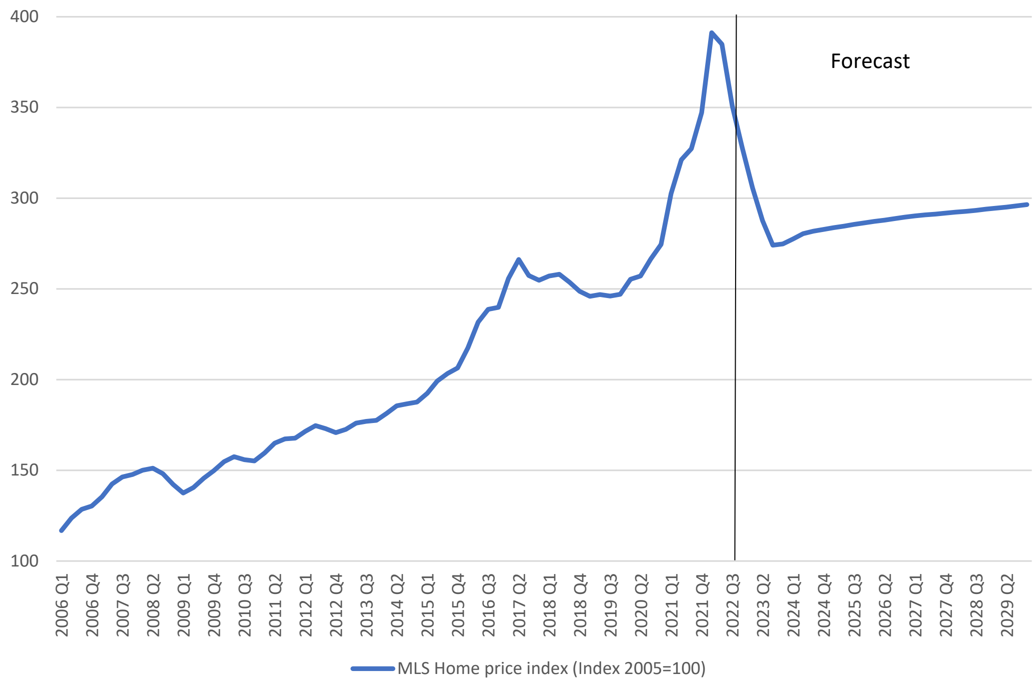
Correlations suggest the Australian dollar remains a view on equity risk as well as yield differentials. In the near term, our top down views suggests equity risk should be supported by lower US inflation however as growth slows (as the probability of a hard landing rises) this should be accompanied with equity weakness, particularly if the Fed are reluctant to cut interest rates. We ultimately see the Fed becoming more dovish, but this presents a likely volatile path for "Aussie". We also see downside risks to the RBA rate path, leaving us neutral vs USD overall.

CAD (-) No support from commodity prices and domestic downturn

Commodities should not be supportive of CAD

Source: Macrobond, Citigroup, 15 December 2022

While the housing market downturn should be a drag



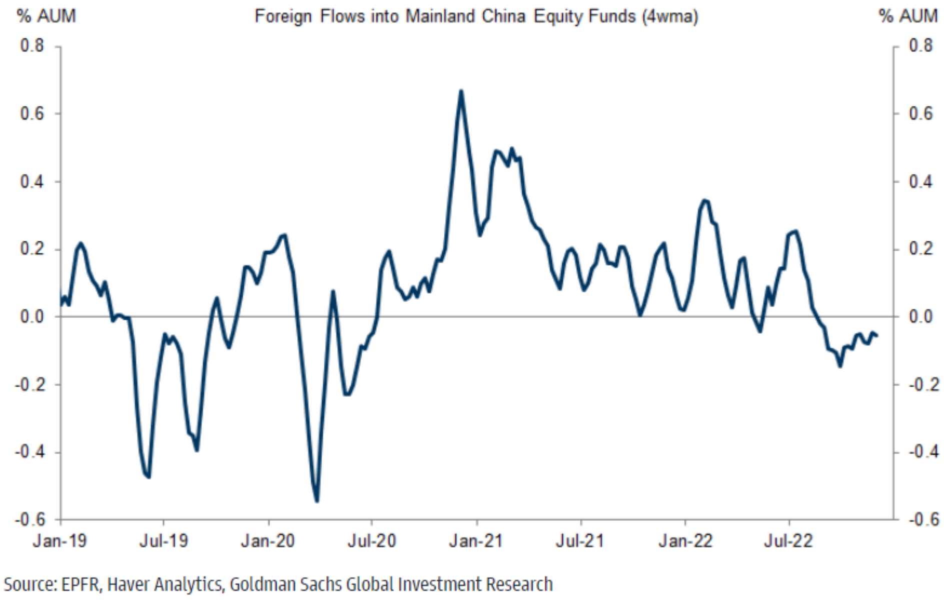
Source: Oxford Economics, MGI Economics, 13 December 2022

The fall in commodity prices, which is the main driver of the Canadian dollar, should not be supportive of CAD. Additionally, we expect 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. We expect the BoC 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.

MILLENNIUM GLOBAL

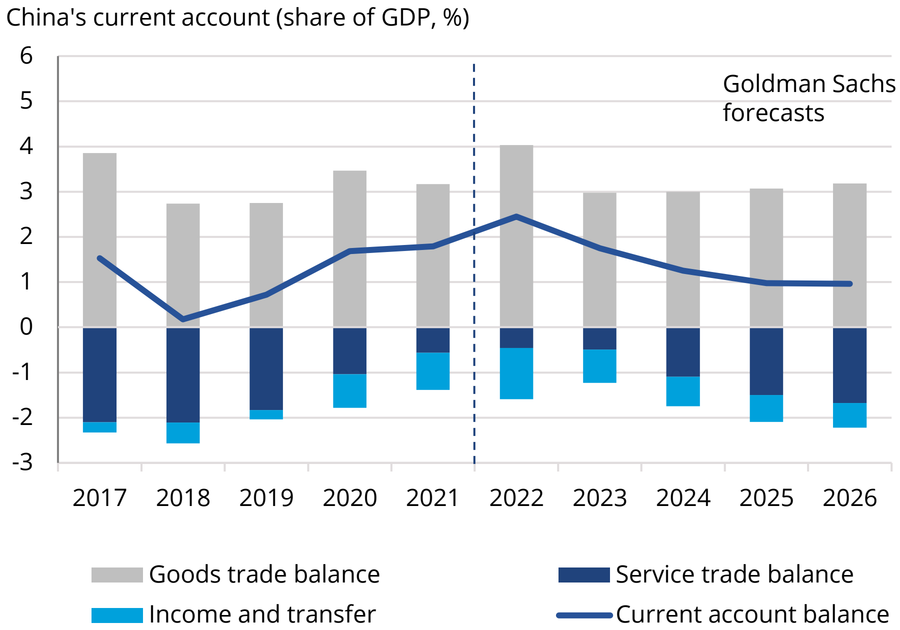
CNH (+) Reopening growth and sentiment supportive

Scope for equity flows to pick up



Source: Goldman Sachs, 12 December 2022

Gradual reopening should limit services outflow widening



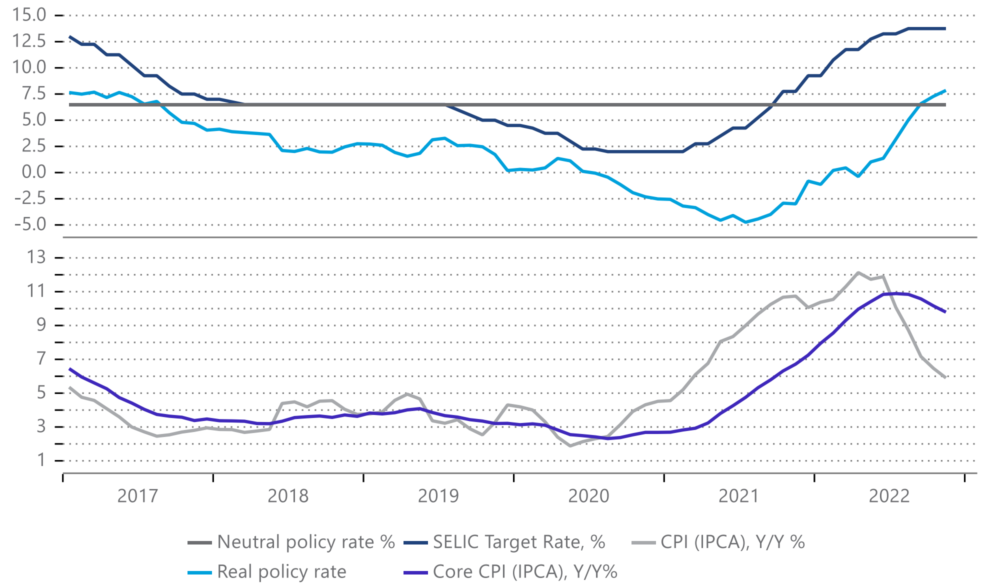
Source: Goldman Sachs (Forecasts), MGI Economics, 12 December 2022

In mid-November China began the reopening process and policymakers are now signalling a focus on supporting growth next year. 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 next year. 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.

MILLENNIUM GLOBAL

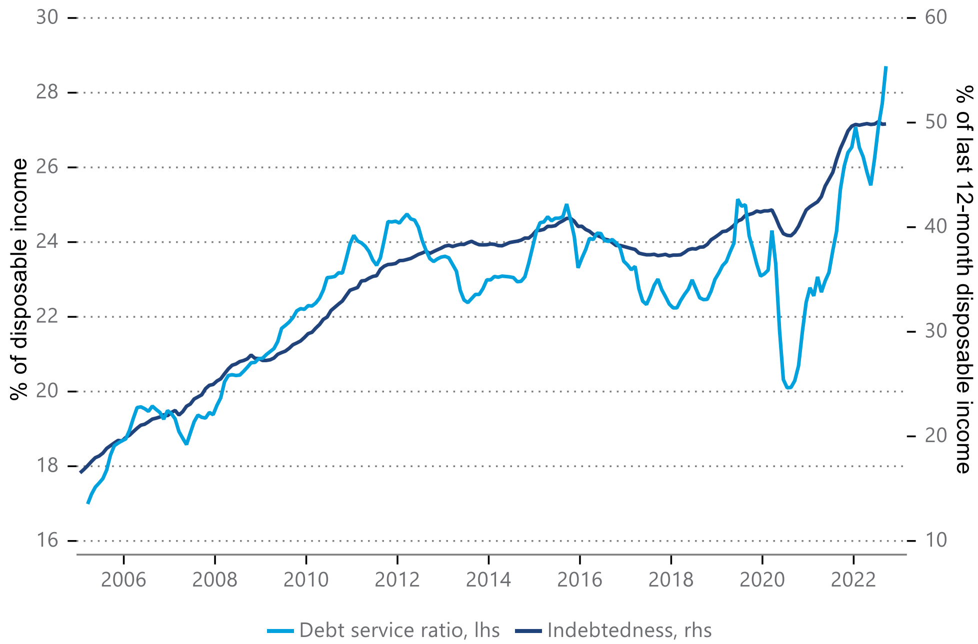
BRL (0) Tight financial conditions and high indebtedness

Restrictive monetary policy to tame inflation



Source: BCB, Macrobond, MGI Economics, 14 December 2022

Raises risks for households indebtedness.



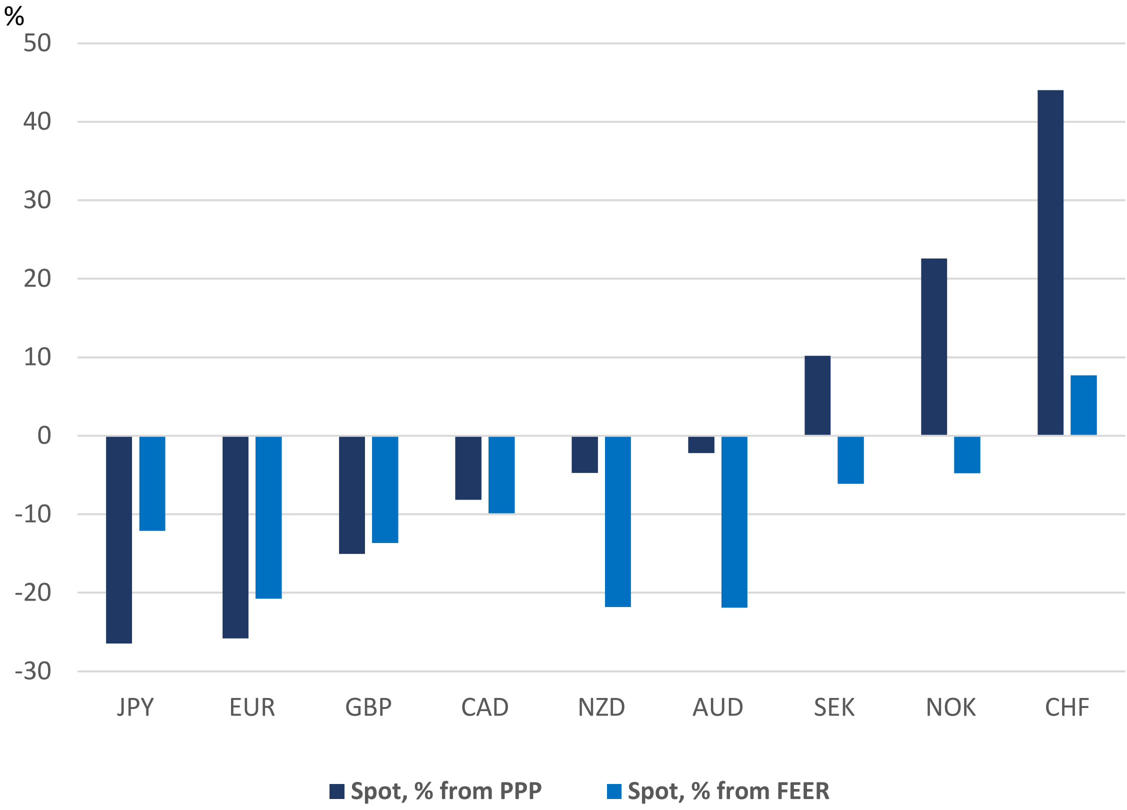
Source: BCB, J.P. Morgan, MGI Economics, 14 December 2022

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, we take a neutral view on BRL versus USD as high nominal rates should broadly offset the negative currency drivers.

FX VALUATION MEASURES

G3 present a valuation opportunity

G10 Valuation measures



Purchasing Power Parity (PPP)

One of the pillars of long run modelling for exchange rates. The main idea is that the price of similar goods in home and foreign countries should be the same, in order to have the respective currencies in equilibrium. Otherwise, a demand switch from the expensive goods to the cheaper goods, will follow. Based on the Law of One Price (LOP), this demand change will last until the demand and supply equalize the prices.

Fundamental Equilibrium Exchange Rate (FEER)

The equilibrium exchange rate that achieves both the internal and external balance. The internal balance is reached when the economy is at full employment and low inflation, while the external balance is reached when a country spends and invests abroad no more than the other countries spend and invest in it.

NOK, SEK and CHF vs EUR. Otherwise vs. USD. Source: Macrobond, MGI Economics, GS Research. Data as of 12 December 2022

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