FX Monthly Report

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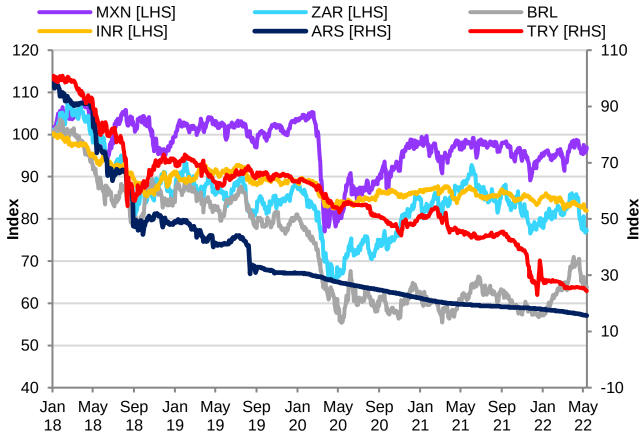
Central Bank Focus

Since the turn of the year, central banks have been in focus as the global economy shifted from returning to growth in 2021 to managing inflation in 2022. We saw E.M. central banks raise rates in 2021, and our previous reports have highlighted the elevated interest rates in countries like Brazil, India, South Africa, Mexico and Russia. Turkey should have been included in this group; however, their unorthodox monetary policy as President Erdogan chops and changes the central bank's governor. Most of these currencies performed well in Q1 2022, as the Fed were slow to react to rising inflation.

EM Currencies Indexed January 2018

EM Currencies, except MXN, have struggled to take back long term losses.



Source: Sucden Financial

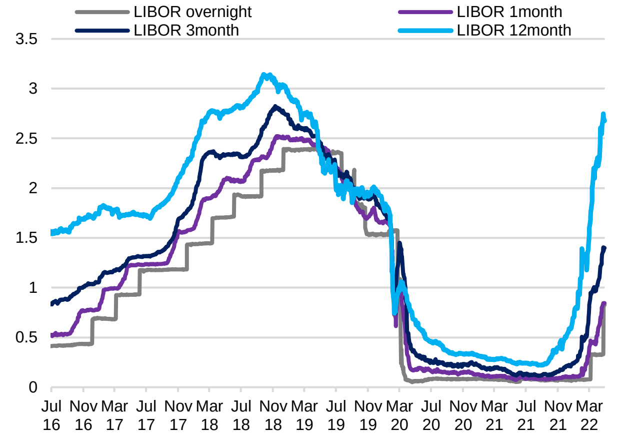
LATAM

Inflation remains a problem in Latin America, with Brazil's CPI at 12.13% Y/Y for April, Chile, Peru, Mexico, and Colombia are also high at 10.5%, 8%, 7.7%, and 9.2%, respectively, on a Y/Y basis. LATAM central banks have raised rates and are expected to continue this path, with Chile, Brazil, and Colombia raising rates in June. However, interest rates in some of these countries are nearing levels which will become detrimental to the economy. Brazil's inflation has continued to increase at an alarming rate, as food/beverage and transportation costs rise rapidly due to the global energy crisis and high food prices, which show no respite. It is no surprise then that on an interest rate return basis, 5 of the top 10 best returns YTD are LATAM countries: Argentina (1), Brazil (5), Mexico (6), Chile (7), Colombia (8). Three of the other countries are Turkey, Russia, and South Africa. Interestingly 5 of the 10 worst performers are from Asia.

Currency returns from LATAM countries are also high, with the same countries in the top 10. However, dollar strength in April eroded some of those gains as the Fed started to tighten, and Europe's economy remains on a very rocky path due to the energy crisis, Ukraine conflict, and rising inflation. The Brazilian Real, Peruvian Sol, and Argentine Peso have gained above 5% YTD. The carry trade is firmly intact, with U.S. and European rates widespread. Even with the Fed raising rates aggressively, they are still comparatively low. We expect dollar strength to remain through to the end of Q3. Carry trades for LATAM currencies remain profitable this YTD with USD as the base currency. However, most of the gains in Q1 have been given back with a few LATAM currencies in the top-performing carry trades. Yield curves have flattened across the globe; Brazil's curve is inverted, with the 2yr yield at 13.15% and the 5yr at 12.56%. For Mexico, the spread between the 2yr and 10yr is 0.13%; higher rates are expected to combat inflation, which softens in 2023. LATAM performance has run out of steam with currencies and equity indices declining; we believe the carry to suffer as USD strength continues in the next 5 months. Using the EUR as the base currency for the trade has yielded a more significant return so far this year, and with the ECB less hawkish on rates, we expect this to remain the case in the near term, but LATAM currency performance has been weaker in the last month.

US Libor Rates

LIBOR rates continue to increase in line with interest rates and bond yields.



Source: ICE Benchmark Administration, Sucden Financial

U.S.

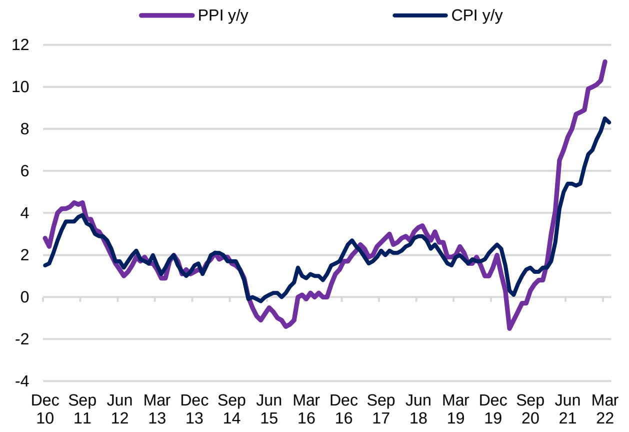
CPI data on May 11th showed that M/M inflation growth softened due to lower energy costs. Inflation expectations are starting to grow slower, CORE inflation did increase, but by less than the previous month at 6.2% Y/Y compared to 6.5% Y/Y. CPI Ex Food and energy increased more than expected at 0.6% Y/Y. We expect energy prices to hold above $100/bl and then push higher, and grains prices will also stay elevated in the coming months. While inflation expectations have increased, energy prices fell 6% in the month prior, but as mentioned, we expect prices to rally again. Shelter costs are the largest services component, and 1/3rd of the overall index increased 0.6% and rent also increased 0.6%. The significant rise was from electricity and gas, up 13.7% Y/Y.

The USD has surged higher in the last month as the economy continues to hold up compared to the rest of the world. Even though we saw GDP in Q1 decline by -1.4%, this was skewed by imports and, as a result, robust consumer demand. Personal consumption was strong at 2.7% Y/Y Q1, a marginal improvement on last quarter, which was 2.%. Bond yields have been well bid as price sell-off. The curve has flattened significantly as interest rates rose and the Fed became even more hawkish. As of March 11th, the market was pricing in rate hikes in March, May, and June, with July and September at 80% probability. The path shows hikes at an implied rate of 1.882% as of February 2023. However, as we fast forward to May 11th, the implied rate as of February 2023 is 2.9/3%, with rate hike probabilities in June, July, September, and October all above

100%, with June and July at 200% and 197%. 50bps rate hikes are nailed on in June and July. However, the back end of the curve is starting to price 30bp rate hikes from September onwards as economic data is expected to weaken further. As a result, we expect the dollar to remain firm until the end of Q3. We do not expect dollar strength to be due to diverging monetary policy but back to economic fundamentals. Indeed, rates may still be high compared to other major economies.

US PPI vs CPI (Year on Year)

LIBOR rates continue to increase in line with interest rates and bond yields.



Source: Bureau of Labour Statistics

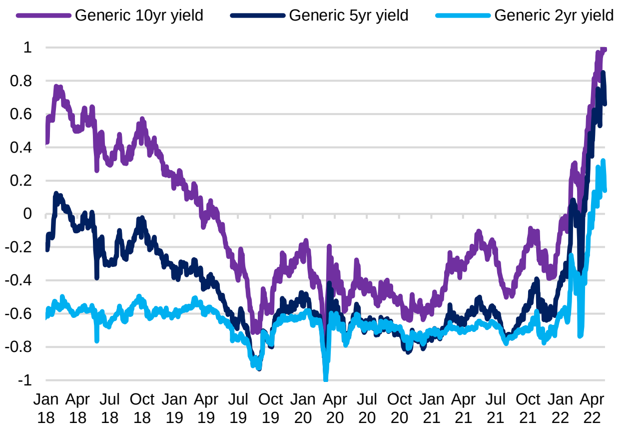
Bond yields have rallied significantly as inflation expectations rose and the Fed started raising rates; 50bps was a disappointment to some market participants who wanted 75bps. To counteract inflation, interest rates would have to reach 5% in the U.S., significantly damaging the economy. We already see home sales decline with M/M sales with 2-months of declines, and mortgage rates have also increased with the average 30yr loan at 5.3%, the rise in mortgages is the equivalent of a 20% increase in home prices (Bankrate.com). The 10yr yield has edged lower from 3%, but in our view, we could see the 10yr top out at 3.40%. The 2yr yield has hovered around 2.5% since the latest Fed meeting. The U.S. H15 constant maturity 10yr real yield is positive at 0.21% as of May 12th. The U.S. treasury inflation-linked yield curve shows tenors out to 7yrs as negative.

Europe

The EUR has been battered as other major central banks such as the BOE and Fed raise rates, but the ECB have kept negative rates intact. The ECB has held firm, and we do not expect rates to rise in June. We expect language to indicate a rate rise in July and September, but they have stated they will not raise rates until asset purchases end. We expect rates to through the second half of the year. Still, interest rates will not be positive until December, so the divergence between U.S./U.K. rates and Europe will be significant even if the Fed is entering the final part of its cycle at the end of 2022. The EUR has been sold in recent months due to the energy crisis and deteriorating economic data, and the divergence in rates as the Fed has frontloaded rate hikes. Slower growth is causing bond yields to decline, and we expect economic data to weaken further and inflation growth to moderate. This could present a downside to rate expectations, but the ECB will still raise rates this time.

European Bond Yields

Financing levels have dipped but we expect a strong recovery in Q1 2022.

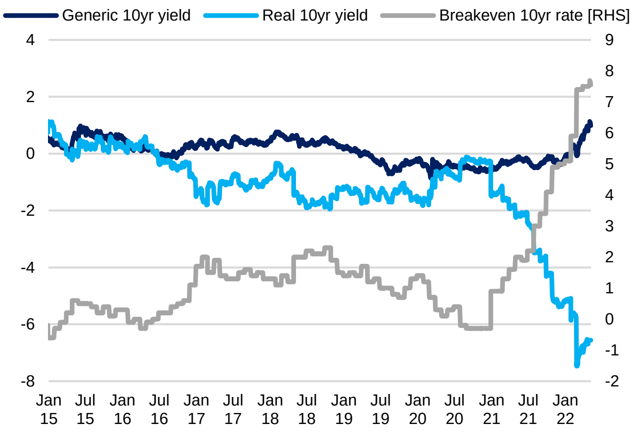


Source: Bloomberg Generic

European yields have all rallied so far in 2022; however, yields have weakened as bonds have been bid in the last few sessions. The ECB's Q.E. policy has particularly squeezed the German bund. Bundesbank bank's holdings of federal securities is close to the ECB's unofficial limit of 50%. However, the Q.E. from the ECB is on the decline, and this, in conjunction with increased bond issuances, will reduce the scarcity of bunds. We assume the removal of Q.E. does not ignite a euro-area bond predicament. We expect inflationary pressure to be more pronounced in Europe due to the energy crisis.

European 10yr Breakeven vs Real Yield vs 10yr Yield

Real yields have nosedived as inflation rises but the B/E 10yr has rallied.



Source: Bloomberg Generic

U.K.

The BOE has raised rates in the last few months to combat inflation. The implied interest rate in March 2023 is now 2.2%. However, the probability of a rate hike is 33.5%. The probability for the next two meetings is above 100% but we could see the momentum of hikes start to slow as higher rates impact growth. If the Fed start to slow its pace of rate hikes towards the end of the year, we could favour GBP over USD in the swaps market. The back end of the curve for 2022 is expected to move, and at this time, this could favour GBP. However, slowing growth and softer inflation expectations could prompt downside to rate hike expectations in the U.K. as economic data continues to weaken. The curve is very flat, and there is not much movement even out 3 years.

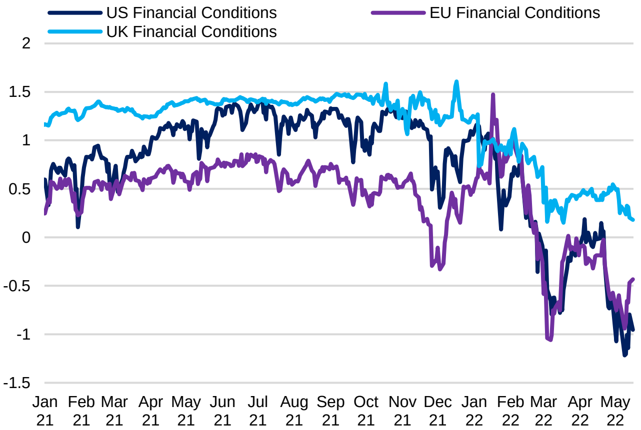
The energy crisis will continue in Europe, and food prices will also rise. Cost of living has increased significantly in 2022, consumer demand will soften, as will economic growth and rising rates into weaker data is problematic. Higher mortgage costs, borrowing costs, and reduced investment from firms will reduce the possibility of more robust growth. The BOE have referenced lower growth and inflation in their latest report. Inflation will start to fall but is a long way off the target rate of 2%, and we also expect unemployment to rise next year, with the BOE expecting a rise to 3.9% in 2023 and 4.6% in 2024. As a result, the tightening monetary policy will not be appropriate, cost inflation will mitigate, and some participants are already calling for peak inflation in G10.

As a result, we expect U.K. rates to have upside in the near term but see downside to the market expectations of rate hikes in 2023. This could see rates top out around 2.3% before investors focus on weaker growth and softer inflation expectations, limiting yields. Political risk continues to create noise, and this has caused GDP to struggle against G10 countries.

Currency View

U.S., and Europe Monetary Policy Conditions

Financial Conditions have declined sharply in the last few months due to poor liquidity and rising rates.



Source: Bloomberg

LATAM: High inflation and rising rates have supported LATAM currencies, but now we are seeing consistent USD strength, which has prompted the gains to be given back. We favour using EUR as a base currency for a carry trade as they are slower to raise rates due to the poor economic outlook. Returns in the last month for carry trades and interest trades have been lower but are still up YTD.

U.S.: The USD has surged higher against most currencies, and we expect this to continue. Yields still have upside, but risks are mounting due to lower growth expectations. Unemployment is low, and while the U.S. is relatively isolated from the Ukraine crisis, it is not immune to these cost pressures. We expect the economy to soften, but unemployment is expected to remain low, and wages have improved, putting consumers in good shape when inflation retreats. We expect the USD to continue to stay strong, and even if the pace of rate hikes is slow, interest rates will likely be higher than in other major economies, especially the euro area.

Europe: The ECB is stuck between a rock and a hard place as inflation rises. GDP for Q1 is forecast to grow at 0.2%. However, the U.K. economy was weaker than expectations, and we could see Europe's contract. Germany grew at 0.2%, up from -0.3% the quarter before. Consumer and business sentiment is declining sharply, and this will compound issues. The ECB is expected to start raising rates, but interest rates will not be positive until at least December or 2023. We expect EUR to be under continued pressure, but there will be value in the currency in Q3 as inflation will moderate, and the issue will be growth.

U.K.: The BOE will continue to raise rates in the near term, but we believe the market is pricing too many rate hikes. This presents a downside to forecasts for peak yields, and while the curve is flat moderating inflation could see near term rates consolidate as longer-term rates edge higher. However, if the participants continue to price into many hikes, we could favour selling the backend of the curve. GBP has suffered against G10 currencies, and even though rates are rising, weak economic fundamentals and a dire political backdrop present headwinds.

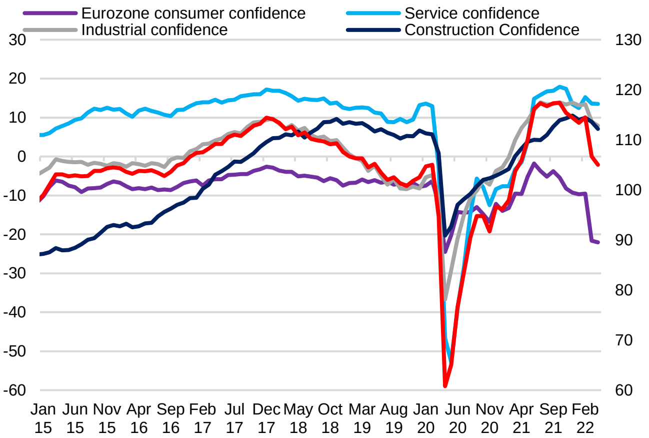
Desk Comments

Euro

The heightened pressure of near-term inflation means its reasonable to expect the ECB to act earlier than previously stated. Inflation reached new record highs of 7.5% in April, significantly higher than expectations. Risks are skewed to the upside with further disruptions to the supply of gas and oil from Russia and slowing demand as China goes into lockdown. Several governing council members have become more vocal, sending a message of urgency to the market. The neutral members of the council are favouring the hawks. However, with no evidence of wage growth, the ECB will need to act cautiously. As a result, we are now expecting rates to be lifted as early as July, followed by several 25bp hikes at a much slower pace than the US but we do expect rates to be positive by the end of the year.

European Sentiment

European sentiment has nosedived in the last few months, we expect this to continue.



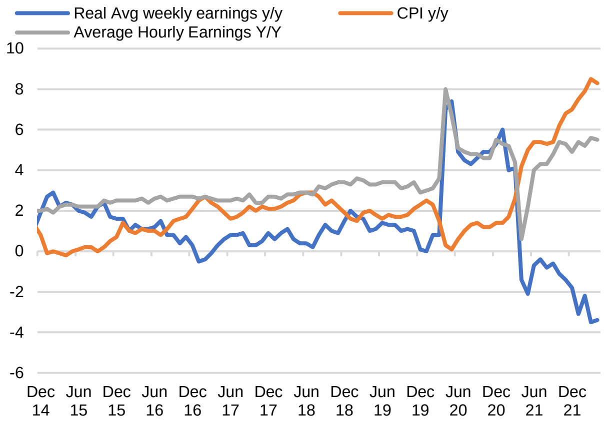
Source: Bloomberg

USD

The Fed raised rates by 50 basis points this month in line with broad market expectations and signalled next 2 meetings are likely to be same and not 75basis points as some market participants feared. The USD has continued to rise over the last 6 weeks gaining against all the majors with USD index up over 9% year to date. As we mentioned in our last report, we do believe the most hawkish scenario has been priced in the market and should slow down USD appreciation. The recent Dollar strength has been led by large droves of risk aversion driven mainly by concerns of slowing growth outside of the US. European growth vulnerabilities amid supply constraints, Chinese growth downgrades as they battle with covid via lockdowns and geopolitical risks from Russia's invasion of Ukraine are contributing factors.

Real Weekly Earnings vs Average Hourly Earnings vs CPI

CPI is rising significantly but M/M gains are slowing, real wages are still contracting.



Source: Bureau of Labour Statistics

Concerns of hard landing for the US Economy and its contagion impact on the rest of the world amid the looming steep rate hike in the US is also weighing on market sentiment and, in our opinion, a likely scenario. The FED and Powel are committed to getting inflation back under 2% and as things stand US Economy is growing, they have strong Labour market, so they will not hesitate in continuing this rates path to get inflation back under control. Our view stays unchanged, we expect the USD start consolidating around these levels with a slight upside basis over the next few months before we see the USD depreciating towards the end of year as US growth slows amid monetary tightening.

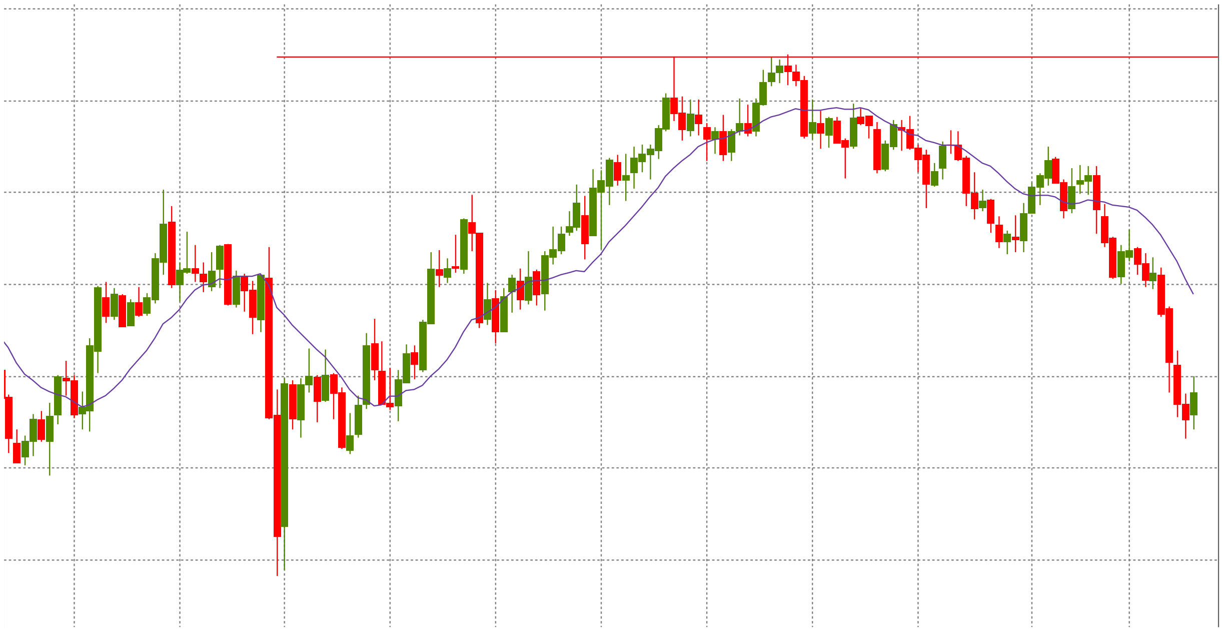
GBP

It's a similar story in the UK as with other global economies. The increased risks of inflation are driving the BOE to tighten its monetary policy at a faster pace than previously forecast. BOE hiked 25bp as expected but kept a softer guidance in place when talking about further hikes. In addition, the weaker growth outlook, and the pace of tightening in the US has seen GBP down 6% against the USD this past month. We now expect the policy rate to be at 2% by the end of the year with a further 4 hikes this year.

A squeeze on UK incomes is likely to intensify in Q3 when the energy price cap expires and the government hike on taxes takes its toll. It's estimated that real household disposable income will drop by 3.4% and without an increase in wage growth the only way consumption will hold up is for households to borrow more. It's a problematic cycle for the BOE and one they must handle with caution to find the right balance of fighting inflation whilst preventing the economy from entering recession.

Technical Analysis

GBPUSD



GBPUSD has formed a strong downtrend after breaking below 1.30. Next test now is the 76.4% FIB 1.2081/1.2076 line and psychological 1.20 Level. We expect this level to provide support and could see GBPUSD bounce as GBPUSD prints more than 3 standard deviations from mean indicating move is overextended for the time being. Last time this occurred saw the currency bounce strongly in March 2020. On the Downside, a break below 1.20 could lead to further downward move to 1.15 and the low from March 2020 @ 1.1412.

EURUSD

EURUSD has continued to trend lower meeting our First target @ 1.0691. On the downside, after breaking below 1.0636 we expect the market to test support @ 1.0341 and then extend to our second target of 1.03. Next support beyond there is at 1.02 (from 2002) and psychological parity level. On the upside, Resistance is @ 1.0636, with a close above indicating a larger pull back to 1.10.

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