

FX Strategy

USD Strength Intensifies With Peak Unlikely This Year

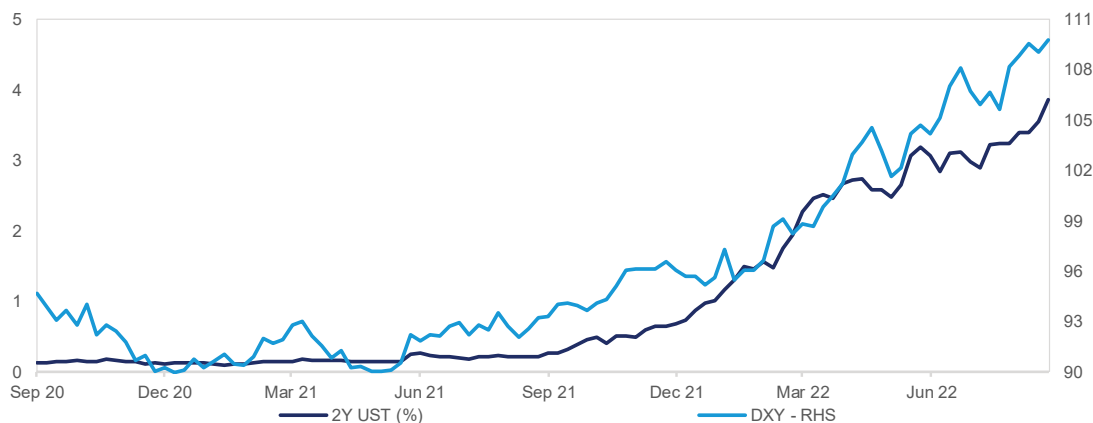
- We expect a peak in DXY in 1Q23 when FFTR reaches its terminal rate.
- That said, the path to a DXY peak is fraught with uncertainties.
- Asia FX will see extended weakness following sustained slide in CNY.

FX volatility stayed elevated as markets swung between hopes of a Fed pivot and subsequent despair after a resolute message from the Fed to fight against persistently high inflation at Jackson Hole.

Underpinned by aggressive Fed rate hike expectations, the US Dollar Index (DXY) rose for a fifth straight quarter in 3Q22 and touched the highest levels in over two decades. FX volatility stayed elevated as markets swung between hopes of a Fed pivot and subsequent despair after a resolute message from the Fed to fight against persistently high inflation at Jackson Hole. A stronger than expected Aug US CPI print also put to rest any expectations of more regular-sized rate hikes in the near term. As US fundamentals still appear sound at this juncture, the Fed can afford to look past growth concerns and prioritize its fight against inflation. We expect the Fed to press on with larger-than-usual rate increments of 75 bps in Nov, 50 bps in Dec before delivering the final 25 bps hike this cycle in Feb 2023 to reach the terminal Fed Funds Target Rate (FFTR) of 4.5-4.75%.

Chart 1: The DXY Rally May Lose Steam After 2Y UST Yield Peaks In 4Q22

Source: Bloomberg, UOB Global Economics & Markets Research



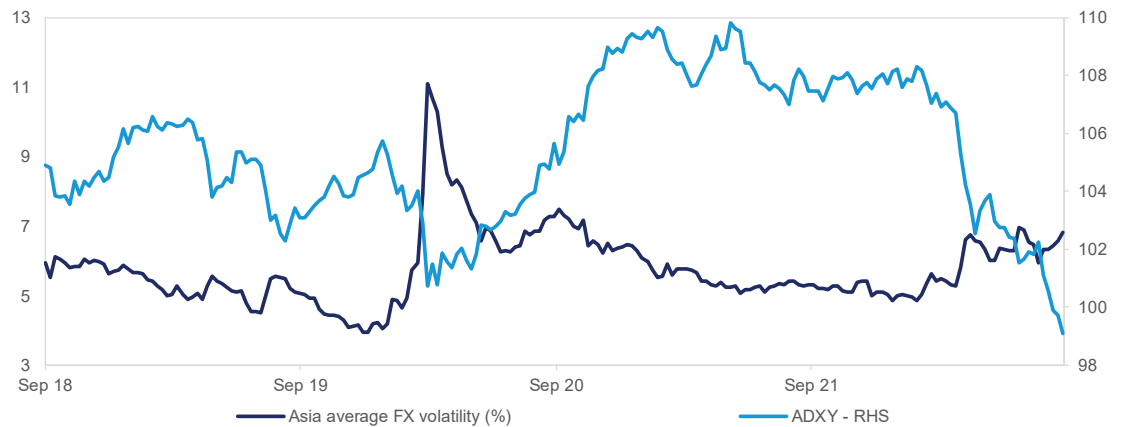
As we now see a peak in the 2-year US Treasuries yield at 4.85% in 4Q22, this is likely to portend a peak in DXY a quarter later in 1Q23 when FFTR reaches its terminal rate.

As to when the DXY will peak, it's important to note that Fed rate hike expectations has been a key driver for the DXY in this cycle. Particularly, the front end of the curve – the 2-year US Treasuries yield – has been instrumental in the surge of the DXY. As we now see a peak in the 2-year US Treasuries yield at 4.85% in 4Q22, this is likely to portend a peak in DXY a quarter later in 1Q23 when FFTR reaches its terminal rate. That said, the path to a DXY's eventual peak is fraught with uncertainties if the string of recent policy surprises is any indication. Already in Sep, the Bank of Japan (BOJ) intervened to prop up the JPY for the first time since 1998 while the GBP crashed to fresh record lows after UK government announced sweeping tax cuts that led to questions about the sustainability of UK finances.

Like their developed peers, Asia FX weakened further in 3Q22 and the Asia Dollar Index (ADXY) fell to the lowest level in 19 years. The prospect of further portfolio outflows as the Fed continues its aggressive front-loading of rate hikes while Asia central banks normalize monetary policies on a more gradual basis keeps Asia FX on the defensive. Renewed weakness in the CNY past its psychological level of 7.0 against the USD has exacerbated pressure on Asia FX. Aside to Fed policy, China is likely the wildcard that will determine of Asia FX in the coming quarters. Unlike their developed peers, Asia FX is unlikely to turn the corner soon as risks to the Chinese economy and the CNY are still biased to the downside. We continue to expect Asia FX to stay weak through 3Q23 as the CNY sustained on the weaker end of 7.00 against the USD.

Chart 2: Rising FX Volatility Lends Runway For Further Asia FX Weakness

Source: Bloomberg, UOB Global Economics & Markets Research



Major FX Outlook
Likely To Get Worse for EUR and GBP

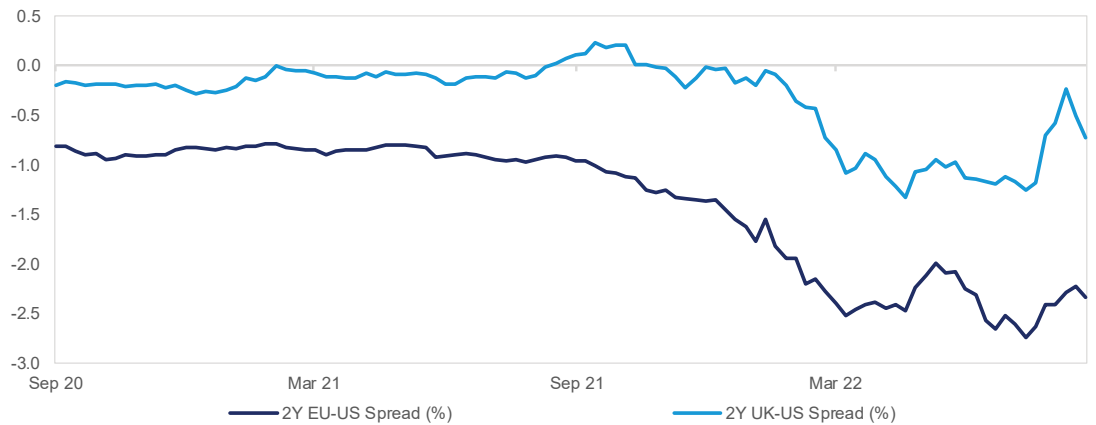
The spectacular DXY rally from the lows of about 90 in Jun 2021 to current levels of just above 110 may be entering its final stage. Previously drawing strength from the series of aggressive Fed repricing across the last one-and-a-half year, this favourable tailwind on DXY may start to falter as the Fed eventually slows and halts its tightening cycle in 1Q23. The Fed cannot afford to ignore US growth headwinds in 2023 as it did in most part of this Fed tightening cycle. The aggressive Fed rate hikes would eventually exert its toll on the US economy and based on our forecasts for the US unemployment rate profile, we are of the view it is very likely that the US will enter into a recession by the start of Jun 2023, if not earlier.

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Overall, alongside a peak in US rates at the end of 2022, a further narrowing of US rate differentials with its G-10 peers may play a bigger role in the expected recovery of Major FX in 2023. A caveat to the view is US inflation still not showing signs of slowing down by the end of 2022 which causes the Fed to stay the course of larger-than-usual rate increments into 2023.

Chart 3: A Further Narrowing Of US Rate Differentials With Its G-10 Peers May Play A Bigger Role In The Expected Recovery Of Major FX In 2023

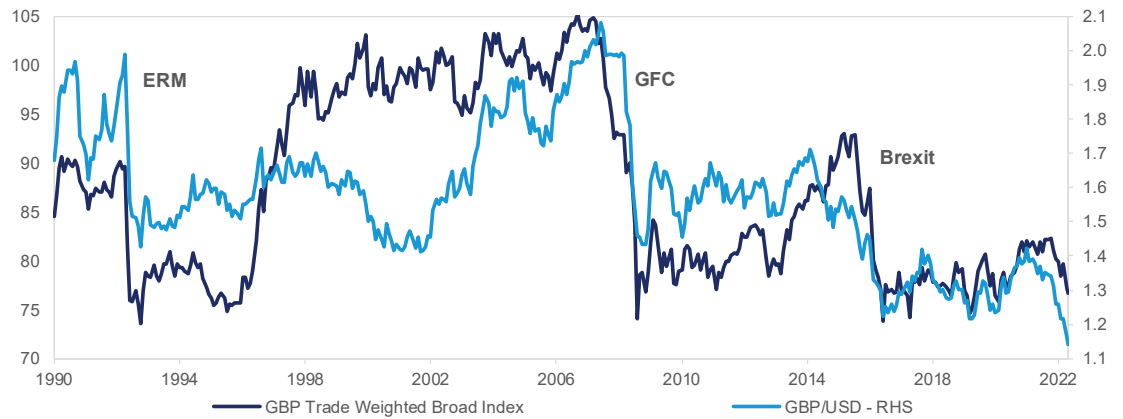
Source: Bloomberg, UOB Global Economics & Markets Research



EUR/USD cracked below the psychological parity level late Aug and touched a 20-year low of 0.9554. With the energy crisis in Europe expected to worsen into winter, near term economic outlook of Eurozone remains bleak. As such, we expect further weakness of EUR/USD towards 0.95 in 4Q22 and 1Q23. In 2023, as the energy crisis ebbed, we are cautiously optimistic that a further recovery in the EU-US rate differential as the Fed starts to pause would spur a modest recovery in EUR/USD. This in on the pretext that Eurozone slowdown would not be severe enough to flip the ECB back into full-blown crisis mode, usually involving cutting rates towards zero and reviving bond purchases. Overall, we reiterate our “hockey stick” view on EUR/USD, expecting the pair at 0.95 in 4Q22 and 1Q23, 0.98 in 2Q23 and 1.00 in 3Q23.

Chart 4: GBP Is Trading At Crisis Pricing

Source: Bloomberg, UOB Global Economics & Markets Research

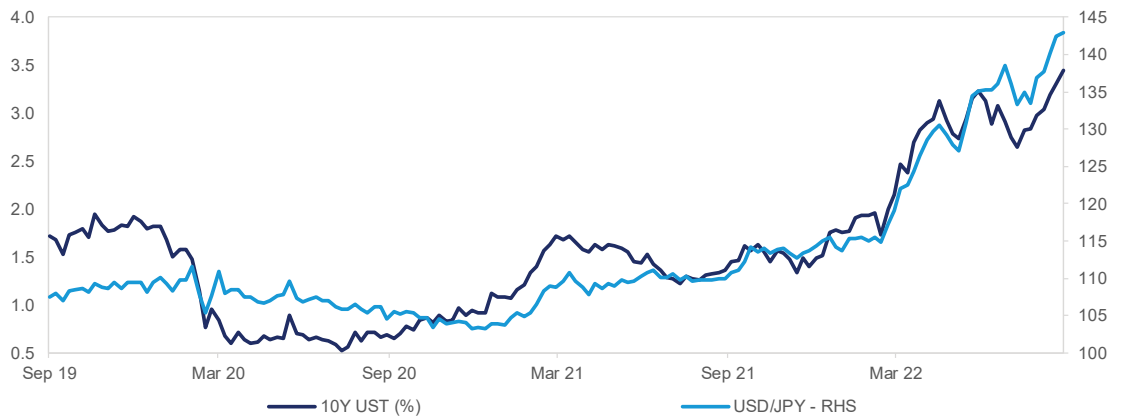


GBP/USD plummeted to record lows of 1.0350 in late Sep as Britain's ballooning twin deficits due to the latest tax cuts compounded worries that UK economy will be slipping into a year-long recession starting 4Q22.

The worst performing G-10 currencies in 3Q22, GBP/USD plummeted to record lows of 1.0350 in late Sep as Britain's ballooning twin deficits due to the latest tax cuts compounded worries that UK economy will be slipping into a year-long recession starting 4Q22. Given the UK macroeconomic instability, it is likely GBP will be the escape valve. We now expect a further decline in the GBP trade-weighted index towards the Brexit (2016) lows of about 73 (from 76 currently) which in turn would drive another leg lower in GBP/USD. While we do not dismiss the prospect of an inter-meeting outsized Bank of England rate hike to stabilize GBP, its longer-term efficacy remains questionable given the fragile outlook of the UK economy and the broad-based strength of the USD. Overall, we update our GBP/USD forecasts to 1.05 in 4Q22, and 1Q23, 1.08 in 2Q23 and 1.12 in 3Q23. At the same time, we would highlight the meaningful risk that GBP/USD may even exceed our downside forecasts and trade below the parity level given the huge volatility and uncertainty.

Chart 5: The Relentless Rally In USD/JPY May Be Ending As US Yields Eventually Peak

Source: Bloomberg, UOB Global Economics & Markets Research



The upcoming quarter (4Q22) is likely to still a volatile one for USD/JPY as US rates are still biased higher which lend upside to USD/JPY while heightened risk of further intervention may limit its upside.

Volatility in USD/JPY stayed high across 3Q22. A decisively hawkish Sep FOMC pushed USD/JPY to 145.90, the highest level since 1998 before the Ministry of Finance intervened after the Fed meeting to shore up the JPY and brought USD/JPY back towards 140. While the intervention is likely to slow JPY depreciation from here, a longer-lasting reversal of the JPY which has slumped close to 20% (vs USD) this year has to be fuelled either by lower US rates or a change in BOJ ultra-loose monetary policies. The latter is likely close to impossible with BOJ Governor Kuroda recently saying that there is no need to change policy guidance for the next 2 to 3 years (i.e. till 2025). The upcoming quarter (4Q22) is likely to still a volatile one for USD/JPY as US rates are still biased higher which lend upside to USD/JPY while heightened risk of further intervention may limit its upside. We see the 145 level in USD/JPY as a strong resistance which may eventually develop into a long-term peak as US rates start its decline next year. Overall, our updated USD/JPY forecasts are 145 in 4Q22 and 1Q23, 142 in 2Q23 and 139 in 3Q23.

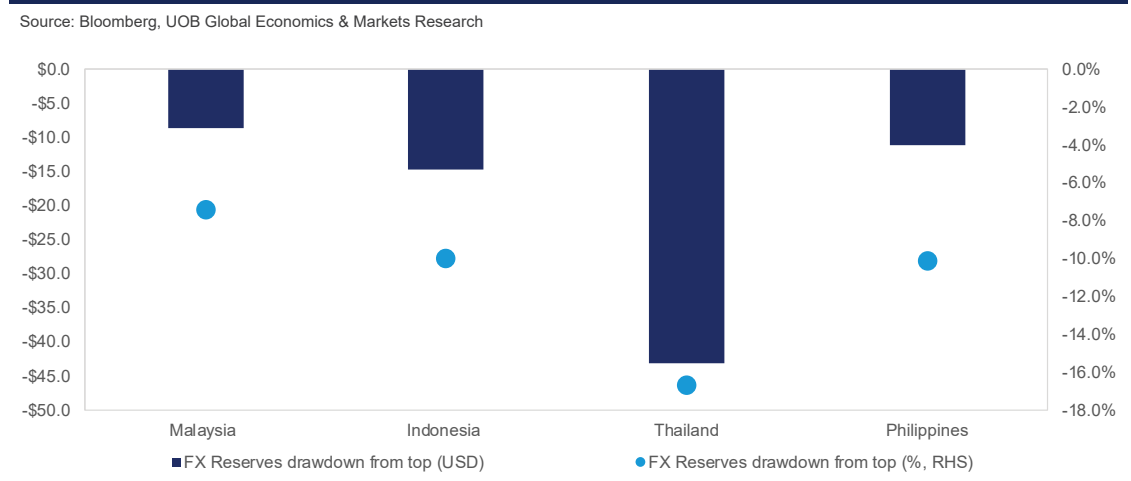
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Commodity-linked FX such as the AUD and NZD which are sensitive to global risk sentiments are likely to be on the backfoot as increasingly restrictive policy raises the odds of a US recession. Another wave of China growth downgrade adds to the pressure on these currencies as demand on commodities slows. As such, we expect commodity-linked FX to stay weak till 1Q23 before a recovery next year as the broad USD strength normalizes. Our updated AUD/USD forecasts are 0.64 in 4Q22, 0.63 in 1Q23, 0.65 in 2Q23 and 0.68 in 3Q23 while that of the NZD/USD are 0.56, 0.55, 0.57 and 0.60 respectively.

Asia FX Strategy Extended Weakness Alongside CNY Slide

Unlike its developed peers, there is still no light at the end of the tunnel for Asia FX at least for the next couple of quarters. While the Fed may start to slow its rate hikes in 1Q23, Asia FX are unlikely to regain its rate advantage just yet due to a very gradual rate normalization trajectory adopted by most regional central banks. So, portfolio outflows are still likely to continue and in response, Asian central banks could draw down their ample FX reserves to smooth volatility on their currencies. By now, it is clear that the CNY has an outsized impact on Asia FX. The symbolic move of USD/CNY above 7.0 in mid-Sep is likely to inject further upside risks to other USD/Asia pairs. Overall, we keep to the upside bias for most USD/Asia pairs in the coming quarters and revise for some as their upside targets are met earlier than expected.

Chart 6: Asian Central Banks Have Drawn Down Their FX Reserves To Smooth FX Volatility

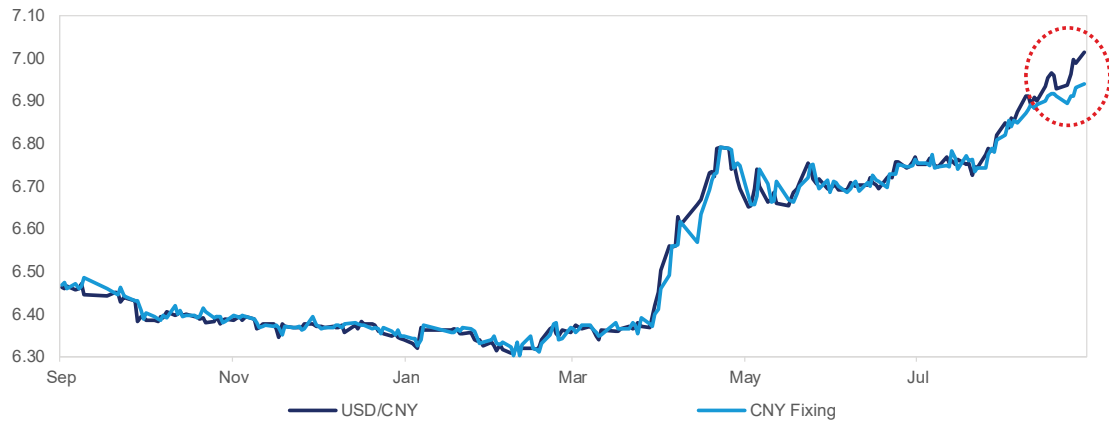


The US-China yield differential is now at the widest against the CNY since 2008, spurring further portfolio outflow from China and keeping CNY on the defensive.

It is not a familiar scene to see CNY ranked as one of the worst performing currencies in Asia given that it has outperformed most regional peers for most part of the pandemic. The rising economic toll of China's zero-COVID strategy is evident on the CNY as it weakened past the psychological 7.0 level against the USD in mid-Sep. While the improvement in retail sales, industrial production and fixed asset investments in Aug provided some relief, economic challenges remain, and authorities have warned that foundations for economic recovery are not solid yet. Another pressure point for the CNY is the widening monetary policy divergence between the PBOC and Fed. The US-China yield differential is now at the widest against the CNY since 2008, spurring further portfolio outflow from China and keeping CNY on the defensive. While the PBOC is unlikely to draw a hard line-on-the-sand at 7.0, it may continue to slow the depreciation of the CNY via measures such as stronger-than-expected CNY fixings or cutting the reserve requirement ratio for foreign currency deposits. Overall, we maintain an upward trajectory for USD/CNY but tweak it slightly to 7.20 in 4Q22, 7.23 in 1Q23, 7.25 in both 2Q23 and 3Q23. They were previously at 7.05, 7.08, 7.10 and 7.12 respectively.

Chart 7: PBOC Leans Against CNY Weakness Via Stronger-than-expected Fixings

Source: Bloomberg, UOB Global Economics & Markets Research

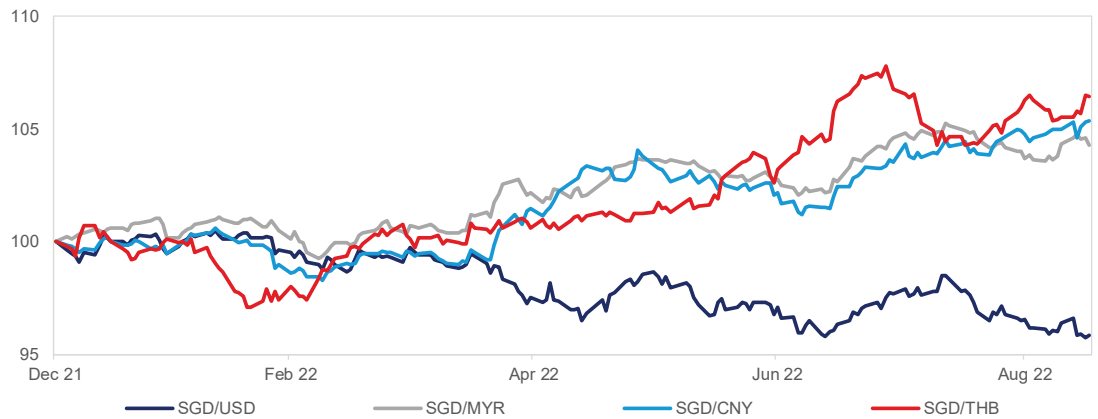


A higher USD/CNY would eventually spill over into USD/SGD and the latter is likely begin a new trading range above the 1.40 level.

The SGD continued to be one of the more resilient currencies in Asia in 3Q22. Despite broad USD strength, USD/SGD only edged up about 2.8% on the quarter to about 1.43 while other USD/Asia rose an average of about 5%. The Singapore dollar nominal effective exchange rate (S\$NEER) rose gradually towards the top end of policy band after the Monetary Authority of Singapore’s (MAS) off-cycle recentring in mid-Jul, signalling further outperformance of the SGD relative to its regional peers just as the MAS is expected to tighten policy further in Oct. That said, a higher USD/CNY would eventually spill over into USD/SGD and the latter is likely begin a new trading range above the 1.40 level. Our updated USD/SGD forecasts are 1.44 in 4Q22 followed by 1.45 through 3Q23.

Chart 8: SGD To Continue To Outperform Regional Peers While Lagging Behind USD

Source: Bloomberg, UOB Global Economics & Markets Research



The MYR broke the 24-year low level of 4.50 in Sep due to the US Fed’s continued hawkishness and persistent CNY weakness amid looming snap election risks in the country. So long as the Fed stays the course for outsized rate hikes (50bps or 75bps) in the coming months and China’s worries persist, MYR will be biased weaker against the USD. We updated our USD/MYR forecasts at 4.63 in 4Q22, 4.67 in 1Q23, and 4.69 in both 2Q23 and 3Q22.

USD/THB traded above 37.0 in Sep, the highest level since 2006 alongside broad Asia FX weakness. Idiosyncrasies such as Thailand’s current account deficit and one of most negative real rates in Asia continue to keep the pressure on the THB, on top of external factors such as aggressive Fed and China slowdown concerns. That said, as the tourism-led economic rebound gains traction and Thailand returns to a current account surplus next year, loss on the THB may start to slow. Overall, we keep to our upward trajectory in USD/THB and update the point forecasts to 38.0 in 4Q22, 38.2 in 1Q23 and 38.4 in both 2Q23 and 3Q22.

Despite strong external headwinds, the IDR was resilient in 3Q22 and was only marginally lower on the quarter to 15,000 /USD. That said, as weakness in the CNY persists and risks that rising inflation may sap the domestic growth recovery, in our view it is inevitable that USD/IDR would eventually sustain above the psychological 15,000 level. Our updated USD/IDR forecasts are 15,200 in 4Q22, 15,300 in 1Q23, 15,400 in both 2Q23 and 3Q23.