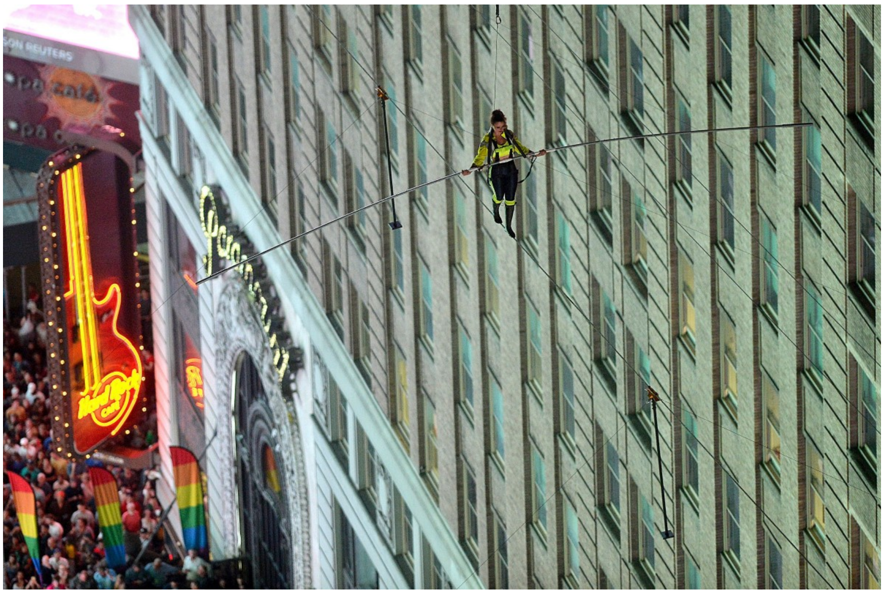
FX Outlook 2023: The dollar's high wire act

The dollar is tumbling from multi-decade highs. Calling the FX market in 2023 requires taking a view on the Federal Reserve, the war in Ukraine, China, and the overall investment environment. We suspect that the dollar can stay stronger for a little longer. But the main message in our 2023 FX Outlook is to expect fewer FX trends and more volatility



Highwire Live in Times Square, New York, USA

Source: Shutterstock

The dollar's highwire act

Having risen around 25% since the summer of 2021, the dollar has recently taken quite the tumble. For 2023, the question is whether this is the start of a new bear trend or whether the factors that drove the dollar to those highs still have a say.

Given that the most liquid FX pair, EUR/USD, was such a large driver of global FX trends in 2022, we use a scenario approach to look at a range of 2023 EUR/USD outcomes – derived from the expected volatility priced into the FX options market. The range of scenarios and end-year FX levels extend from 'Permacrisis', where EUR/USD could be trading at 0.80, to 'Safe and Sound', where

EUR/USD could be closer to 1.20.

Key inputs to that scenario approach are factors like: i) how aggressive the Fed will be, ii) Ukraine, Europe, and energy, iii) China, and iv) the overall risk environment. Given ING's house view of the Fed taking rates to 5.00% in early 2023, four quarters of recession in Germany amid higher energy prices, relatively weak Chinese growth, and a still difficult equity environment, our baseline view favours softer EUR/USD levels.

2023 will see fewer FX trends and more volatility

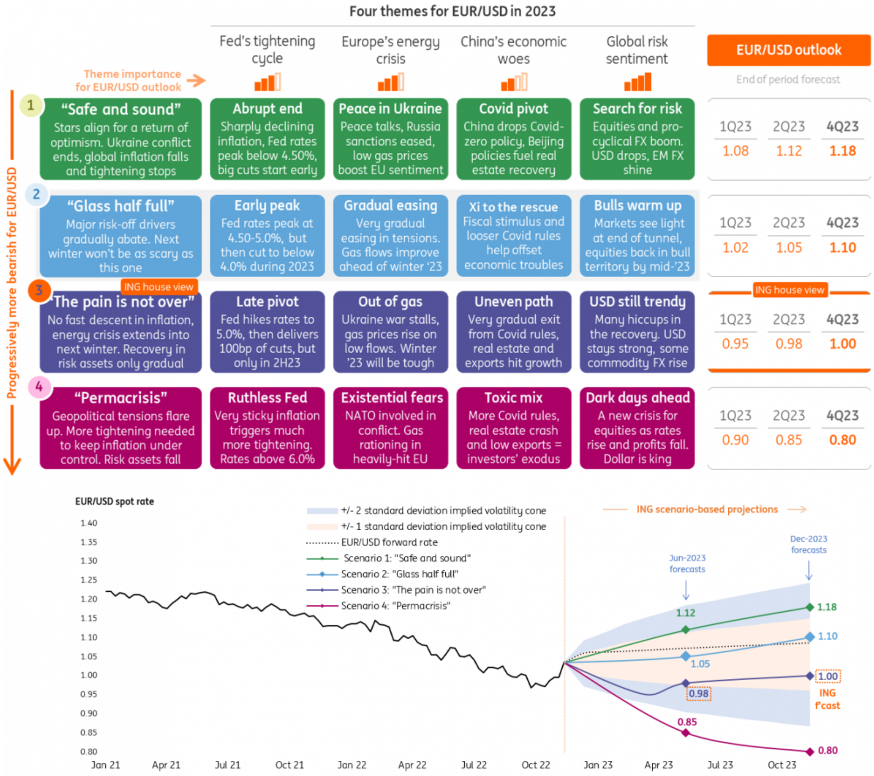
But perhaps the strongest message to get across in our outlook is that FX markets in 2023 will see fewer trends and more volatility. We say this because conditions do not look to be in place for a clean dollar trend – no 'risk-on' dollar decline nor 'risk-off' dollar rally. And central banks tightening liquidity conditions through higher policy rates and shrinking balance sheets will only exacerbate the liquidity problems already present in financial markets. Volatility will stay high.

Softening global activity and trade volume growth at less than 2% will likely limit the gains of pro-cyclical currencies in 2023. EUR/USD could be ending the year near 1.00. If the positive correlation between bonds and equity markets does break down next year, it will likely come through a bond market rally. Our forecast for US 10-year Treasury yields at 2.75% year-end will argue for USD/JPY to be trading at 130 or lower.

EUR/USD will set the tone for European currencies in general. We favour the Swiss franc to outperform and sterling to underperform. Scandinavian currencies may continue to struggle with the high volatility environment. Further east, we see scope for the Hungarian forint to be re-assessed positively, while the overvalued Czech koruna and Romania leu look more vulnerable as FX intervention slows.

In the commodity bloc, the uncertain outcome for China continues to place a question mark on the Australian and New Zealand dollars. We again prefer the Canadian dollar – although how the housing market correction plays out will be a risk. USD/CNY itself may struggle to sustain a move sub-7.00. And in a more mixed FX environment, expect local stories to win out – one of which may be Korean debt being included in world government bond benchmarks – helping the won.

EUR/USD: Four scenarios for 2023



Source: ING, Refinitiv

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