

Our three FX calls for 2022

We expect the dollar to stay strong, commodity currencies to remain in demand and investors to have to work hard to identify returns in emerging market FX



1 Don't mess with the dollar

Assuming that Omicron risks play out closer to the benign end of the spectrum, our team looks for the sharper Fed tightening cycle to return as a theme in early 2022. This should be good news for the dollar. Here the US economy's positive output gap should mean that the Fed moves to the forefront in the G10 policy normalisation story in 2022 – and that the dollar plays its part in tightening US monetary conditions.

In a world where the European Swiss and Japanese central banks are late to tighten – or have the biggest cause to pause – dollar gains should largely come at the expense of the low-yielding currencies. Here EUR/USD can trade to 1.10 through the year and USD/JPY potentially as high as 120. Helping these trends will be European and Japanese investors reducing FX hedge ratios on US investments because of the high cost of dollar hedging, while US investors will happily increase FX hedge ratios on European and Japanese investments – being paid to do so.

2 Commodity currencies have more to offer

2021 has proved a mixed year for commodity currencies, but 2022 should be better. We think their

current valuations do not fully reflect the terms of trade gains seen in 2021 and the positive income shock delivered to their economies. Here, strong profits particularly among the energy exporter community should lead to enduring business investment trends and provide local central banks, such as those in Canada and Norway, with the confidence to extend tightening cycles, perhaps by as much as 100bp in both countries in 2022.

In addition, Norway's krone has struggled to reclaim the liquidity-induced collapse in March 2020 and scores cheap on medium-term valuation models. The Canadian dollar has the benefit of the support from the strong US final demand story next year.

3 Emerging market FX requires Alpha to be sought

Emerging market currency trading in 2021 proved that it was not simply enough to take a 'risk-on, risk-off' view of the world and trade the asset class accordingly. The Alpha, the excess returns over the benchmark index, were very much determined by local stories. The same should be true for 2022. One big theme for next year will be if and when Chinese authorities allow the very strong renminbi to correct lower. That could be a story in the second half should priorities shift from protecting importers to protecting exporters.

Elsewhere, emerging currency trends will be determined by themes such as the pandemic, central bank reaction functions and politics. There are big elections across many regions next year (Hungary and Brazil to name but two) and how policymakers handle inflation, growth and sovereign balance sheets will be very much in focus. Of the bigger emerging currencies, we would probably favour the Mexican peso, backed by strong US growth and a central bank looking to insert a near 6% policy rate buffer over the US.

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