2023 FX Outlook

16 November 2022

Follow us
@ING_Economics

Chris Turner
Global Head of Markets and Regional Head of Research, UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

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

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.

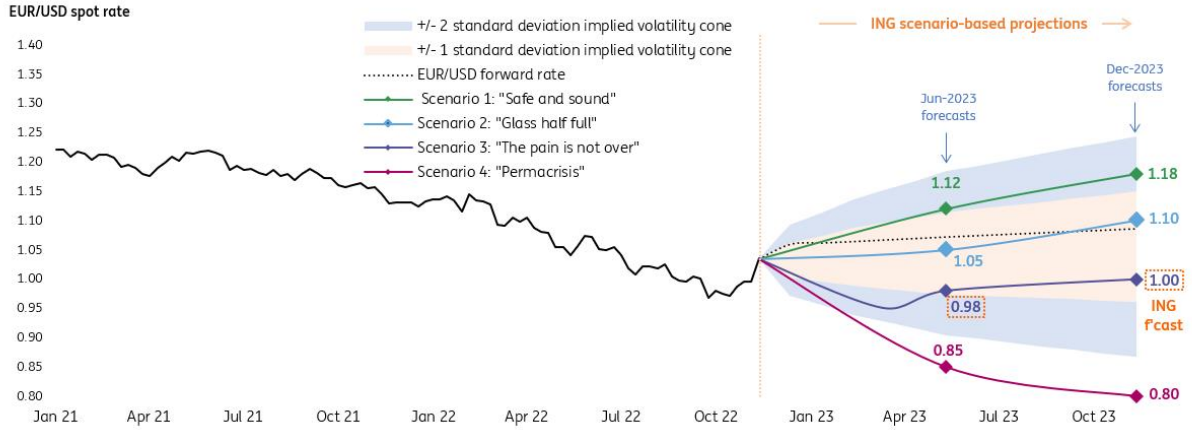
In the commodity bloc, the uncertain outcome for China continues to place a question mark on the Australian and New Zealand dollars. We again prefer the Canadian dollar – although how the housing market correction plays out will be a risk. USD/CNY itself may struggle to sustain a move sub-7.00. And in 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.

Four themes for EUR/USD in 2023

Theme importance for EUR/USD outlook

Progressively more bearish for EUR/USD

		Fed's tightening cycle	Europe's energy crisis	China's economic woes	Global risk sentiment	EUR/USD outlook (End of period forecast)
1	**"Safe and sound"** Stars align for a return of optimism. Ukraine conflict ends, global inflation falls and tightening stops	**Abrupt end** Sharply declining inflation, Fed rates peak below 4.50%, big cuts start early	**Peace in Ukraine** Peace talks, Russia sanctions eased, low gas prices boost EU sentiment	**Covid pivot** China drops Covid-zero policy, Beijing policies fuel real estate recovery	**Search for risk** Equities and pro-cyclical FX boom. USD drops, EM FX shine	1Q23 1.08; 2Q23 1.12; 4Q23 1.18
2	**"Glass half full"** Major risk-off drivers gradually abate. Next winter won't be as scary as this one	**Early peak** Fed rates peak at 4.50-5.0%, but then cut to below 4.0% during 2023	**Gradual easing** Very gradual easing in tensions. Gas flows improve ahead of winter '23	**Xi to the rescue** Fiscal stimulus and looser Covid rules help offset economic troubles	**Bulls warm up** Markets see light at end of tunnel, equities back in bull territory by mid-'23	1Q23 1.02; 2Q23 1.05; 4Q23 1.10
3 (ING house view)	**"The pain is not over"** No fast descent in inflation, energy crisis extends into next winter. Recovery in risk assets only gradual	**Late pivot** Fed hikes rates to 5.0%, then delivers 100bp of cuts, but only in 2H23	**Out of gas** Ukraine war stalls, gas prices rise on low flows. Winter '23 will be tough	**Uneven path** Very gradual exit from Covid rules, real estate and exports hit growth	**USD still trendy** Many hiccups in the recovery. USD stays strong, some commodity FX rise	ING house view: 1Q23 0.95; 2Q23 0.98; 4Q23 1.00
4	**"Permacrisis"** Geopolitical tensions flare up. More tightening needed to keep inflation under control. Risk assets fall	**Ruthless Fed** Very sticky inflation triggers much more tightening. Rates above 6.0%	**Existential fears** NATO involved in conflict. Gas rationing in heavily-hit EU	**Toxic mix** More Covid rules, real estate crash and low exports = investors' exodus	**Dark days ahead** A new crisis for equities as rates rise and profits fall. Dollar is king	1Q23 0.90; 2Q23 0.85; 4Q23 0.80



Source: ING, Refinitiv

G10 FX Outlook 2023: Less trend, more volatility

Chris Turner
Global Head of Markets and Regional Head of Research, UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

After an 18-month bull trend in the dollar, the FX outlook has become less clear. Further position adjustment could prompt a little more short-term dollar weakness, but we do not believe the conditions are in place for a major dollar bear trend just yet. Instead, we expect FX markets in 2023 to be characterised by less trend and more volatility

G10: Less trend, more volatility

The final quarter of 2022 has seen a breakdown in the otherwise orderly dollar bull trend – a trend which had been worth 5% per quarter over the first nine months of the year. That dollar rally had largely been driven by a Federal Reserve wanting to take policy into restrictive territory – a trend only exacerbated by the war in Ukraine.

For all the current discussions about peak dollar and peak macro pessimism, we think it is still worth examining whether the conditions will be in place to deliver an orderly dollar bear trend in 2023. We think not and here are three reasons why:

1) Driving the dollar bull trend since summer 2021 has been a Fed at first abandoning Average Inflation Targeting and then trying to get ahead of the inflation surge. A call on a benign dollar decline in 2023 requires the Fed to be taking a back seat. That seems unlikely. The stark message from both the Fed's Jackson Hole symposium and the IMF autumn meetings was that central banks should avoid relaxing too early in their inflation battle – a move which would deliver the pain of recession without any of the sustained gains on inflation. We suspect it will be too early for the Fed to sound relaxed at its 14 December meeting and March 2023 may be the first opportunity for a decisive turn in Fed rhetoric.

2) While a softer Fed profile may be a necessary condition for a turn in the dollar, a sufficient condition requires a global economic environment attractive enough to draw funds out of the dollar. 2023 global growth forecasts are still being cut – dragged lower especially by recession in Europe. ING forecasts merchandise world trade growth below 2% in 2023 – not a particularly attractive story for the trade-sensitive currencies in Europe and emerging markets.

3) A liquidity premium will be required of non-dollar currencies. 2023 will be a year when central banks are initially still hiking into a recession and shrinking balance sheets. The Fed will reduce its balance sheet by a further $1.1tn in 2023 and the European Central Bank will be looking at quantitative tightening, too. Lower excess reserves will tighten liquidity conditions still further and raise FX volatility levels. Again, the bar not to invest in dollar deposits remains high – especially when those dollar deposits start to pay 5% and the dollar retains its crown as the most liquid currency on the planet.

What do these trends mean for G10 FX markets? This probably means that the dollar can bounce around near the highs rather than embark on a clean bear trend in 2023. If the dollar is to turn substantially lower, we would favour the defensive currencies such as the Japanese yen and Swiss franc outperforming. Here, the positive correlation between bonds and equity markets may well break down via the bond market rallying on the back of a US recession and easier Fed policy. ING forecasts US 10-year Treasury yields ending 2023 at 2.75% - USD/JPY could be trading at 130 under that scenario.

Recession in Europe means that EUR/USD could be trading in a 0.95-1.05 range for most of the year, where fears of another energy crisis in the winter of 2023 and uncertainty in Ukraine will hold the euro back. Sterling should also stay fragile as the new government attempts to restore fiscal credibility with Austerity 2.0. We cannot see sterling being rewarded much more on austerity and suspect that GBP/USD struggles to hold gains over 1.20.

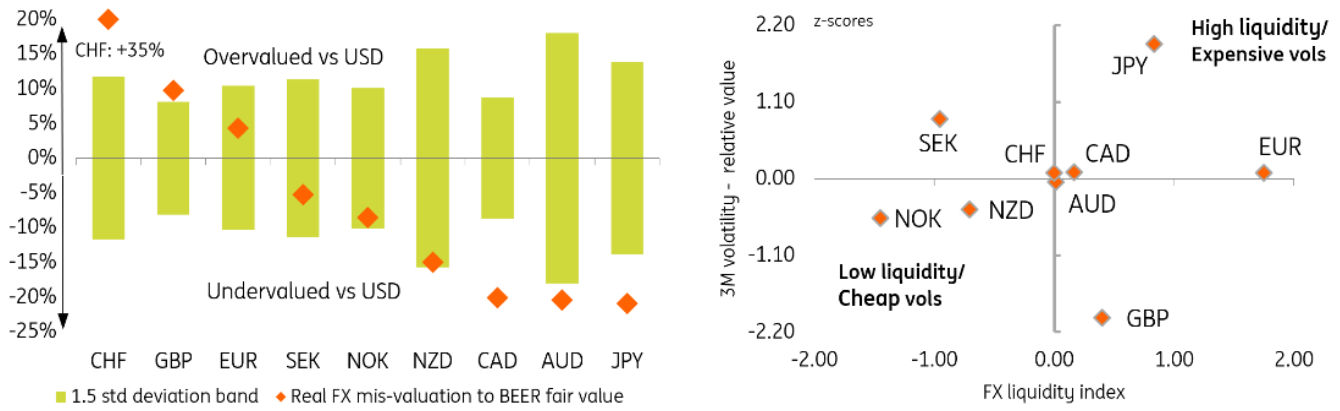
Elsewhere in Europe, some differentiation could emerge between the Scandinavian currencies. The Swedish krona may struggle to enter a sustained uptrend next year given its elevated exposure to the eurozone's growth story, while the Norwegian krone could benefit from its attractive commodity exposure. However, NOK is an illiquid and more volatile currency, and would therefore face a bigger downside in a risk-off scenario.

As shown in the chart below, commodity currencies look undervalued versus the dollar on a fundamental basis. However, a stabilisation in risk sentiment is a necessary condition to close the misvaluation gap. For the Australian and New Zealand dollars, an improvement in China's medium-term outlook is also essential, so the Canadian dollar may emerge as a more attractive pro-cyclical bet given low exposure to the economic woes of Europe and China.

Another factor to consider is the depth of the forthcoming house price contraction. We think central banks will increasingly take this into consideration and will try to avert an uncontrolled fall in the housing sector. However, this is potentially a very sizeable downside risk, especially for the currencies of commodity-exporting countries, which generally display the most overvalued property markets in the G10.

To conclude, we think FX trends will become less clear in 2023 and volatility will continue to rise. FX option volatility may seem expensive relative to historical levels, but not at all when compared to the volatility FX pairs are actually delivering. We suspect risk management through FX options may become even more popular in 2023.

Valuation, volatility and liquidity in G10



Source: ING, Refinitiv

EUR/USD: Dollar bromance will take some breaking

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/USD	1.0350	Bearish	0.98	0.95	0.98	1.00	1.00

Bullish leap of faith is too dangerous: We are bearish on EUR/USD into the end of the first quarter of 2023. Key factors which have driven EUR/USD lower this year will remain largely in place. The softish US October CPI print may give the Fed some pause for thought, but should not be enough to derail it from some further tightening – taking the policy rate close to 5.00% in the first quarter of 2023. Another key factor for EUR/USD this year has been energy. Here, our team sees prices for both natural gas and oil rising from current levels through 2023. A difficult 2023 European winter for energy may well restrain the EUR/USD recovery later in the year, continuing to depress the eurozone's traditionally large current account surplus.

Necessary but not sufficient: Tighter Fed policy has been at the forefront of this year's dollar rally and a shift in the Fed tone (more likely in March 2023 than December 2022) will be necessary to see the short end of the US yield curve soften appreciably and the dollar weaken. But the sufficient condition for a EUR/USD turnaround is the state of affairs amongst trading partners. Are they attractive enough to draw funds away from USD cash deposits potentially paying 5%? That is a high bar and why we would favour the EUR/USD 2023 recovery being very modest, rather than the 'V' shape some are talking about.

ECB will blink first: The case for a central bank pivot is stronger for the ECB than the Fed. The German economy looks set to contract 1.5% next year and at its 15 December meeting, the ECB may well use its 2025 forecast round to show inflation back on target. We see the ECB tightening cycle stalling at 2.25% in February versus the near 3% currently priced by the market for 2023. This all assumes a seamless ECB introduction of quantitative tightening and one that does not upset peripheral bond markets. Add in global merchandise trade barely growing above 1% next year (recall how the 2017-19 trade wars weighed on the euro) plus the risk of tighter liquidity spilling into financial stability – all suggest the market's bromance with the dollar will continue for a while yet.

USD/JPY: 1Q23 will be a crucial quarter

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/JPY	140.00	Bearish	145.00	145.00	140.00	135.00	130.00

Clash of the titans: The stark divergence in monetary policy between the Fed and the Bank of Japan has been the primary driver of this year's 15%+ rally in USD/JPY. In 2023, investors may question whether the BoJ is ready to tighten. The default view is that the perma-dovish BoJ Governor, Haruhiko Kuroda, will not be moved. However, the end of Governor Kuroda's term on 8 April 2023 will no doubt lead to frenzied speculation on his replacement and whether a less dovish candidate emerges. Interest rate markets are starting to price a change – e.g. the BoJ's 10-year target sovereign yield of 0.25% is priced at 0.50% in six months' time.

March 2023 will be especially volatile: The first quarter of 2023 will also see huge focus on the Japanese wage round, where a rise in wages is a prerequisite for the BoJ to tighten policy. Japanese politicians have been encouraging business leaders to raise wages, while at the same time, the government has been quite aggressive with fiscal stimulus to offset the cost-of-living shock. This period will also see the Fed release its dot plots (22 March), which may be the first real chance for the Fed to acknowledge a turn in the inflation profile. As such, this period (March/April) could see a big reversal lower in USD/JPY.

FX Intervention slows the move: Most agree that USD/JPY is higher for good reasons (including the energy crisis) and that Japanese FX intervention can only slow, not reverse the move. The Japanese have already spent around $70bn in FX intervention between the 146 and 151 region in USD/JPY and will likely be called into further action based on our view of a stronger dollar over coming months. FX reserves are not limitless, of course, but Japan's large stockpile of $1.1tn means that this campaign can continue for several more months. The purpose here is to buy time before the Fed cycle turns. Unless we end up with 6%+ policy rates in the US next year, we would expect USD/JPY to be ending 2023 nearer 130.

GBP/USD: Running repairs

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
GBP/USD	1.1900	Mildly Bearish	1.10	1.07	1.11	1.14	1.14

Fiscal rescue plan: After September's government-inflicted flash crash, GBP/USD is now recovering on the expectation of more credible UK fiscal plans and the softer dollar. As above, we doubt 2023 will prove the year of a benign dollar decline. And the risk is that the Fed keeps rates at elevated levels for longer. Given sterling's large current account deficit and its transition to high beta on the external environment, we think it is too early to be expecting a sustained recovery here. Instead, we favour a return to the 1.10 area into year-end as the government introduces Austerity 2.0 and the Bank of England cycle is repriced lower.

Tighter fiscal/looser monetary mix: At its meeting in early November, the BoE pushed back against the market pricing of the rate cycle – arguing that hikes close to 5% would see the UK economy contract 5%. Our call is that the BoE terminal rate will be closer to the 3.75% area than the 4.50% that the market prices today. As the BoE assesses the degree of tightening needed to curtail inflation, the government is discussing ways to fill around a £60bn hole in the budget. The plan will be revealed on 17 November, probably in a roughly 50:50 split between tax hikes and real terms spending cuts. We look for the

UK economy to contract every quarter in 2023 – making it a very difficult environment for sterling.

Sterling suffers from liquidity outages: This year's BIS triennial FX survey saw sterling retain its position as the fourth most traded currency pair. Despite this, sterling does occasionally suffer from flash crashes. We think liquidity will be at a premium in 2023 and that a Fed taking real rates even higher as economies head into recession is a dangerous combination for sterling – where financial services make up a large section of the economy. GBP/USD realised volatility is now back to levels seen during Brexit and our market call for 2023 is that these types of levels will become more, not less, common.

EUR/JPY: A turn in the cycle

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/JPY	144.5000	Bearish	142.00	138.00	137.00	135.00	130.00

Downside risks into 1Q23: EUR/JPY has defied typical relationships with risk assets by gently rallying all year even as both bond and equity benchmarks sold off 20%. Driving that JPY underperformance has probably been BoJ policy and USD/JPY's strong relationship with US 10-year yields. Both the eurozone and Japan have been hit by the energy shock, where external surpluses have quickly dwindled. As above, we tend to think there are downside risks to EUR/JPY in the first quarter of 2023 as speculation mounts over BoJ Kuroda's successor as well as the ECB potentially calling time on their tightening cycle at the February meeting.

US10yr can drag EUR/JPY to 130 in 2H23: A large part of the JPY underperformance during 2022 has been driven by developments in the US bond market. USD/JPY consistently shows the most positive correlation to US 10-year Treasury yields of any of the G10 FX pairs – and far higher than EUR/USD. Consistent with ING's view on the Fed cutting rates in the third quarter of 2023, our debt strategy team sees US 10-year yields starting to edge lower in the second quarter of 2023, and then falling 100bp in the second half of 2023. In theory, this should heavily pressure EUR/JPY into the end of the year.

Financial stability risks increase: Lower growth and tighter liquidity conditions – at least through the early part of 2023 – increase the prospect of financial stability risks. Recall the Fed will be shrinking its balance sheet by $1.1tn in 2023 even as liquidity and bid-offer spreads continue to create difficult market conditions. The yen lost its shine as a safe-haven currency in 2022, but we suspect relative to the euro, some of that shine can be regained in a softer US rate environment. The EUR/JPY cycle should also turn if the ECB calls time on its tightening cycle at the 2 February meeting.

EUR/GBP: Listless in London

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/GBP	0.8700	Neutral	0.89	0.89	0.88	0.88	0.88

In the same macro boat: Both the eurozone and UK economies have been hit hard by the war in Ukraine and the surge in energy prices. Both saw sharp terms of trade declines into August and then a sharp reversal as natural gas prices dipped into the warm winter. There is not a substantial amount of difference between our German and UK quarterly growth profiles for 2023 – both contracting every quarter of the year. Perhaps one could argue that the UK is more exposed to higher mortgage rates given

the shorter duration of fixed-rate mortgages in the UK. This could all make for a trendless EUR/GBP environment.

Energy price guarantees could differentiate: One important determinant for UK growth in 2023 will be how the new government handles the Energy Price Guarantee. Former UK Prime Minister, Liz Truss, offered a two-year programme – subsequently cut back to six months after the UK fiscal crisis. How the UK consumer copes with having to pay market prices for energy will be key to the UK story in 2023 as well as how the EU as a whole copes with similar challenges. Currently, it seems that the ECB is concerned that the fiscal programmes in Europe are too generous and not particularly targeted – adding to the inflation challenge.

Political wild cards: To pick out a few political wild cards, the first is a re-run of the Scottish independence referendum. The Scottish National Party (SNP) has picked 19 October 2023 as the date – although such an exercise would likely have to be approved by the UK parliament. Currently, the SNP is pursuing an action through the Supreme Court to see whether London can indeed still veto the referendum. In Europe, the focus will probably be on the fiscal path taken by the new right-wing Meloni government and also the reform of the Stability and Growth Pact. Budgets submitted in late 2023 could become an issue were the rules to be tightened again.

EUR/CHF: Swiss National Bank to guide it lower

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/CHF	0.9800	Bearish	0.95	0.93	0.90	0.90	0.92

Does the SNB want a stronger Swiss Franc?: The Swiss National Bank this year said it made a conscious decision to allow nominal Swiss franc appreciation in light of the inflation environment. The three-month policy rate has been raised 125bp to 0.50% and the SNB says it wants to keep the real exchange rate stable. With inflation running at 3% in Switzerland versus 10% in its largest trading partner, the eurozone, the SNB in theory should be happy with something like 5-7% per annum nominal appreciation in the Swiss franc. That certainly was the story into the end of September but does not quite explain the Swiss franc's weakness over the last six weeks.

Two-sided intervention: When hiking rates earlier this year the SNB also said it would be engaging in two-sided FX intervention. Ever since the start of the financial crisis in 2008, the SNB has been more familiar as a seller of the Swiss franc – including its 1.20 floor in 2011-2015. Now its strategy is changing and we read that as an objective to potentially manage the Swiss franc stronger in line with its ambitions to tighten monetary conditions. Earlier this year, we estimated that the SNB could possibly drive EUR/CHF to the 0.90 area in summer 2023 based on expected inflation differentials and the need for a stable real exchange rate.

The risk environment should favour the franc: Central banks are communicating that they need to tighten rates into recession and remove the excess liquidity poured out during a series of monetary bailouts. Tighter monetary and financial conditions typically spell stormy waters for risk assets. With its still sizable current account surplus (worth 8% of GDP in the second quarter of 2022) the Swiss franc should perform well during this stage of the global economic cycle. Closer to home, the European economic cycle and the ECB discussing quantitative tightening into early 2023 will prove a challenge to peripheral eurozone debt markets and likely reinforce the franc as a eurozone hedge.

EUR/NOK: Not for the faint of heart

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/NOK	10.3300	Bearish	10.30	10.15	9.95	9.70	9.60

Risk sentiment remains key: The krone is not a currency for the faint of heart. It is the least liquid currency in the G10 space, making it considerably exposed to negative shifts in global risk sentiment and equity market turmoil. It is, at this stage, way too early to call for a turn in equities, and a hawkish Fed into the new year may actually mean more pain for risk assets, at least in the near term. A recovery in global sentiment should offer support to NOK in the second half of next year, but restoring market confidence in a very high-beta currency is no easy feat.

Norges Bank policy: The krone's underperformance in 2022 was exacerbated by Norges Bank effectively sterilising oil and gas profits via a large increase in daily NOK sales. In November, FX daily sales have been scaled back from NOK4.3bn to NOK3.7bn, and we think there could be some interest by NB to further ease the pressure on the currency via smaller FX sales. With recent dovish hints suggesting that the NB hiking cycle may peak at 3.0% (with most of the country on variable mortgage rates, many more rate hikes could be difficult to tolerate), allowing a stronger currency to do some inflation-fighting sounds reasonable.

Energy prices: If indeed markets enjoy a calmer environment in 2023 and NB favours a stronger currency, then NOK is left with considerable room to benefit from a still strong energy market picture for Norway. There is probably an optimal range for oil and – above all – gas prices to trade at elevated levels but not such high levels that would significantly hit risk sentiment. For TTF, this could be somewhere around 150-200 €/MWh. This a plausible forecast for next year, but the margin for error can be very large. We see EUR/NOK at 10.50 in the fourth quarter of 2023, but NOK hiccups along the way are highly likely.

EUR/SEK: Eurozone exposure a drag on SEK

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/SEK	10.8000	Neutral	10.85	10.70	10.60	10.40	10.50

Riksbank's policy: The Riksbank delivered more than one hawkish surprise in 2022, including a 100bp rate hike. This appeared to be part of a front-loading operation where lifting the krona was seen as a welcome side effect. In practice, and like in many other instances in the G10, the high volatility environment meant that short-term rate differentials played a negligible role in FX. So, despite a wide EUR-SEK negative rate differential throughout 2022, SEK was unable to draw any real benefit. That differential has now evaporated, but we expect 125bp of tightening (rates at 3.0%) in Sweden versus 75bp in the eurozone, which could suggest some EUR/SEK downside room in a more stable market environment. Also, a slowdown in FX purchases by the RB, now that reserves are back to the 1H19 levels, should remove some of the pressure on SEK.

European picture: Sweden is a very open economy with more than half of its exports heading to other EU countries. Our expectations are that 2023 will see a rather pronounced eurozone recession and that the energy crisis will extend into the end of next year. Barring a prolonged period of low energy prices (and essentially an improvement in the geopolitical picture) in Europe, we doubt SEK will be able to enter a sustainable appreciation trend in 2023 as sentiment in the eurozone should remain depressed.

Valuation: We are not fans of the euro in 2023, which means that our EUR-crosses forecasts reflect the weaker EUR profile. We see some room for EUR/SEK to move lower throughout the year - also considering that we estimate the pair to be around 9.0% overvalued. However, the high risk of a prolonged energy crisis in the eurozone means that SEK is significantly less attractive than other pro-cyclical currencies next year. Incidentally, SEK is highly correlated to the US tech stock market, which looks particularly vulnerable at the moment. A return to 10.00 or below would likely require a significant improvement in European sentiment.

USD/CAD: Loonie is an attractive pro-cyclical bet

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/CAD	1.3300	Bearish	1.34	1.32	1.30	1.26	1.24

Commodities and external factors: Our commodities team expects Brent to average slightly above $100/bbl next year, and Western Canadian Select around $85/bbl. Along with our expectations for higher gas prices, the overall commodity picture should prove rather supportive for the Canadian dollar in 2023. In our base-case scenario, where global risk sentiment gradually recovers but two major risk-off forces - Ukraine/Europe and China - remain, CAD would be in an advantageous position, since Canada has much more limited direct exposure to China and Europe compared to other commodity-exporting economies.

Domestic economy: If the US proves to be a relative 'safe-haven' in the global recession, therefore withstanding the downturn better than other major economies like the eurozone, this should offer a shield to Canada's economy, which is heavily reliant on exports to the US. There is probably one major concern for the domestic economy: house prices. Canada is among the most vulnerable housing markets in the world, with price-to-income ratios around 9x in many cities (compared to 5-6x in the US). Whether we'll see a sizeable but controlled descent or a fully-fledged housing crash will depend on the Bank of Canada and the depth of the recession.

Monetary policy and valuation: It does appear that the BoC has started to consider domestic warning signals (probably, also house prices), and recently shifted to a more moderate pace of tightening. Markets are currently expecting rates to peak around 4.25/4.50% in Canada, and we tend to agree. Barring a rapid acceleration in the unemployment rate, a housing crash should be averted. It is also likely that the BoC will start cutting before the Fed in 2023. All in all, accepting the downside risks stemming from the housing market and/or a further deterioration in risk sentiment, we see room for a descent in USD/CAD to the 1.25 level towards the end of 2023. In our BEER model, CAD is around 20% undervalued in real terms.

AUD/USD: Riding Beijing's roller coaster

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
AUD/USD	0.6800	Mildly Bullish	0.66	0.66	0.68	0.69	0.70

Exposure to China: The Australian dollar is a high-beta currency, and the direction of global risk sentiment will be the key driver next year. We think that a gradual recovery in sentiment will be accompanied by a still challenging energy picture, which may force investors to choose which pro-cyclical currencies to bet on. When it comes to AUD, the China factor will remain very central, as Australia has the most China-dependent export machine in the G10. Our economics team's baseline scenario is that the real estate crisis will be the main drag on growth in China and while retail should recover on looser Covid

rules, slowing global demand should hit exports. One positive development: the new Australian government is seeking a more friendly relationship with Beijing, paving the way for the removal of export curbs next year.

Commodities and growth: Iron ore remains Australia's main export (estimated at $130bn in 2022), and it is a very sensitive commodity to China's real estate sector. Our commodities team thinks a return to $100+ levels is unlikely given the worsening Chinese demand picture, but still forecasts prices to average $90/t in 2023. The second and third largest exports are oil and natural gas ($100bn combined). Here, we see clearly more upside room for prices, especially on the natural gas side. On balance, we expect the commodity picture for Australia to be rather constructive next year, which could offer a buffer to the Australian economy during the downturn. Growth in 2022 should have topped the 4% mark, but that will be much harder to achieve in 2023. The combination of higher rates, reset mortgages, a slowing housing market and possibly softening labour market should bring growth back closer to 3%. This would still be an extremely strong outcome against the backdrop of global weakness.

Monetary policy and valuation: The Reserve Bank of Australia has been one of the 'pioneers' of the dovish pivot, and a return to 50bp increases seems unlikely, as the Bank is probably monitoring the rather overvalued housing market, and the inflation picture is less concerning than in the US or in Europe. Most Australian households have short-term fixed mortgage rates, and we could see a deterioration in disposable income (especially at the start of the year). We think the RBA will be careful to avert an excessively sharp housing contraction, and we expect rates to peak at 3.60% (well below the Fed and the Reserve Bank of New Zealand) and cuts from 3Q23. This would mean a less attractive carry – and less upside risk in an optimistic scenario for global sentiment; but also less damage to the economy, which may play in AUD's favour in our baseline scenario. Valuation highly favours AUD, as the positive terms of trade shock means that AUD/USD is 20% undervalued in real terms, according to our behavioural equilibrium exchange rate (BEER) model. We have a moderately upward-sloping profile for the pair in 2023, but high sensitivity to risk sentiment and China suggests downside risks remain high.

NZD/USD: Dodging the housing bullet

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
NZD/USD	0.6200	Mildly Bullish	0.60	0.60	0.62	0.63	0.64

Monetary policy: The Reserve Bank of New Zealand has given very few reasons to believe it is approaching a dovish pivot. Markets are currently expecting the Bank to hike well into 2023, and take rates to around 5.0%. While inflation (7.2% year-on-year) and job market tightness (unemployment at 3.3%) both remained elevated in the third quarter, there are growing concerns about the rapid downturn in the New Zealand property market, which in our view will trigger either an earlier-than-expected end to the tightening cycle or a faster pace of rate cuts in 2023.

Housing troubles: The RBNZ recently published its financial stability report, where it showed relatively limited concern about households' ability to withstand the forthcoming downturn in house prices. In its August 2022 forecasts, the RBNZ estimated that the YoY contraction in house prices will reach 11.6% in the first quarter of 2023. However, that implied an Official Cash Rate at 4.0%, so only 50bp of extra tightening from now, which seems too conservative now. House prices have fallen 7.5% from their first quarter 2022 peak so far, but the trend may well accelerate, especially given a hawkish RBNZ and the risk of slowing global demand hitting the very open New Zealand economy.

External drivers and valuation: Even assuming a constructive domestic picture in the housing market and an attractive yield for the currency in 2023, external factors will determine how much NZD can draw any benefit. As for AUD, risk sentiment and China are the two central themes. The New Zealand dollar is more exposed to risk sentiment (as it is less liquid and higher-yielding) than AUD, but probably less exposed to China's story. In particular, the real estate troubles in China may well hit Australia via the iron ore channel, while NZ exports (primarily dairy products) are much more linked to China's Covid restrictions, which look likely to be gradually scaled back. In our base case, the two currencies should largely move in tandem next year. The real NZD/USD rate is 15% undervalued, according to our BEER model.

EUR/DKK: Tricky mix of intervention and rates

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/DKK	7.4400	Neutral	7.44	7.44	7.44	7.44	7.45

Central bank policy: Danmarks Nationalbank delivered FX intervention worth DKK45bn in September and October to defend the EUR/DKK peg. On 27 October, it opted for a smaller rate hike (60bp) compared to the ECB (75bp), which briefly sent EUR/DKK close to the 7.4460 February highs before rapidly falling back to 7.4380/90. We think it will be a busy year ahead for the central bank, as we expect very limited idiosyncratic EUR strength and potentially more pressure on EUR/DKK. Having now exited negative rate territory, DN has much more room to adjust the policy rate for a wider rate differential with the ECB if needed. However, with inflation running above 10% in Denmark, DN may prefer FX intervention over dovish monetary policy to support the peg. We have recently revised our EUR/DKK forecast, and expect a return to 7.4600 only in 2024.

CEEMEA FX Outlook 2023: Geopolitical misfortune

Frantisek Taborsky
EMEA FX&FI Strategist
frantisek.taborsky@ing.com

Péter Virovácz
Senior Economist, Hungary
peter.virovacz@ing.com

Dmitry Dolgin
Chief Economist, Russia
dmitry.dolgin@ing.de

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Péter Virovácz
Senior Economist, Hungary
peter.virovacz@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

The geographic and geopolitical situation has made this a difficult period for the region. However, things should normalise in the coming year. We expect global pressures to ease and central banks to drop their FX intervention approach. Nevertheless, the situation remains fragile and we remain vigilant

Winter in Prague

Make the FX market normal again

Although it can be said globally that the last few months have been very complicated, the CEEMEA region and in particular the CEE4 have been clearly leading the way in this mess. The Covid years forced central banks in Central and Eastern Europe to start a global hiking cycle, and this year's events have compounded the burden on the region. In our view, the main shock is already over, but we are far from out of the woods and are only moving into the second stage – the aftermath.

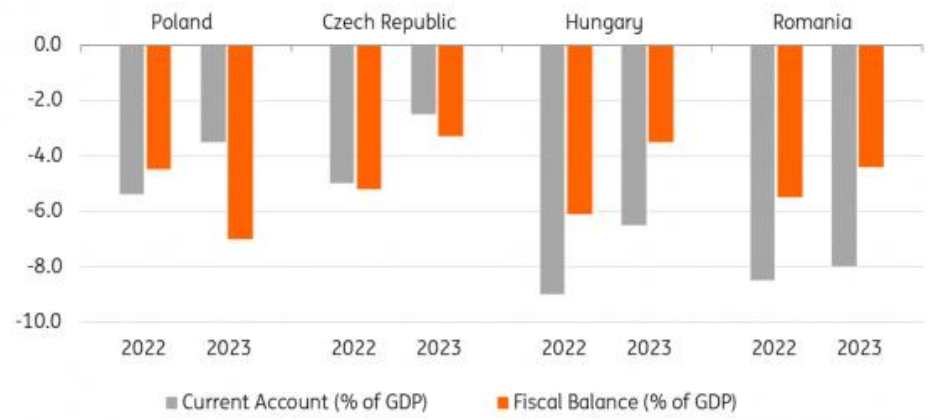
In addition to the standard drivers of FX, such as rate differentials and EUR/USD, the price of natural gas has now become a central theme for the CEE4 region. The coming winter will test the unity of the European Union with a shallow recession and central bank efforts to end record hiking cycles bringing further pain to FX. Moreover, twin deficits, which will remain with us for a longer period, do not play in the region's favour. Central banks have been forced to do more than just hike rates to ensure price stability and the CEE4 region has split into two camps: full FX intervention regimes (Romania and the Czech Republic) and hybrid defence (Poland and Hungary). To make matters worse, politics has also come into play, and in particular, the dispute between Hungary and Poland with the EU has weighed heavily on the forint and the zloty. As you can see, the cards are heavily stacked against the CEE region, and we carry all these themes into the next year.

However, we believe that these issues will be addressed in 2023 and market conditions will begin to normalise. By far the biggest potential, in our view, is the Hungarian forint, which has suffered badly from the government's uncertain access to EU funds, full dependence on Russian energy, and the greatest sensitivity to a global sell-off. Therefore, with the calming of these issues, which we believe is only a matter of time, the hidden potential of the forint could be unlocked, outperforming its CEE peers. We see

a similar story on a smaller scale in Poland. On the other hand, the Czech National Bank and National Bank of Romania have taken the path of keeping FX under control, leading to artificial overvaluation. In both cases, we expect a loosening of the central banks' approach in the first half of next year, which should lead to significant depreciation.

Among the high-yielders, Turkish policymakers have used an array of unorthodox policy measures to limit weakness in the Turkish lira. The Turkish election in June will be a pivotal period for financial markets, and investors will remain wary that unchecked inflation could put pressure on the lira. In South Africa, the rand looks to have found some good buyers near the 18.50 area in USD/ZAR. Those levels could be tested again early next year should the Federal Reserve push real interest rates higher again, but as pessimism in the Chinese economy starts to fade in the second half of 2023, (the rand is very much driven by commodity prices and China's performance) USD/ZAR could be trading well below 17.00. Finally, USD/ILS normally proves a good bellwether for the broad dollar trend. And the Bank of Israel might be slightly more tolerant of shekel strength in 2023. We target 3.00 for USD/ILS.

Twin deficits - the new standard in the region



Source: ING forecast

EUR/PLN: Conditions to improve, zloty remains at risk

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/PLN	4.7000	Neutral	4.90	4.85	4.74	4.66	4.70

Valuation: Our relative value EUR/PLN model (gauging the exchange rate against other market variables, such as swap spreads, option volatility, etc) continues to point to the zloty still being some 3% undervalued against the euro. We attribute this to a mix of risks, both external, particularly the war in Ukraine and its economic fallout, and internal, specifically, tensions with the EU, elevated CPI risk and expansionary fiscal policy undermining the local currency bond market – Polish government bonds (POLGBs). Many analysts suggest another major Russian offensive may be due in the spring. If Russia simultaneously attempts to put economic pressure on the EU, this could again sour sentiment towards the CEE region. The prospect of the conflict coming to an end is a major unknown, but investors should at least become increasingly resilient to news about the war.

External position: Fundamental backing behind the zloty should improve next year, but risks behind the local policy mix will rise. We expect the current account deficit to tighten from €35bn to €26bn, owing to e.g. a more favourable terms of trade. Poland is also likely to draw some €20bn from the 'old' EU budget. Moreover, the government finally decided to lean towards hard currency funding. All of this is likely to be converted via the market under the current Ministry of Finance's FX strategy – balancing the current

account deficit. Also, FDI inflows should remain solid, already standing at a net €16bn in the first half of 2022. Year-end 2022 may prove more difficult, as refilling natural gas reserves may again prove costly.

Politics: Domestic politics is a major unknown in 2023. The proximity of the October elections is a key risk for the fiscal consolidation the government recently unveiled to curtail weak POLGBs. The government is also attempting to reset relations with the EU – possibly encouraged by Hungary's pro-EU turn. While reaching an actual compromise will take time (and may prove impossible ahead of the general elections), it is at least a move in the right direction and likely to improve the market perception of Poland. Moreover, opinion polls show increasing support for the EU-orientated opposition. A victory for them could prove supportive to the zloty, as investors would bet on swift access to the 'new' EU budget.

EUR/HUF: Waiting for a forint breakout

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/HUF	405.0000	Bearish	400.00	390.00	380.00	385.00	390.00

Inflation: The forint's (HUF) underperformance is largely related to price pressures. Despite the anti-inflationary measures provided by the Hungarian government via price caps in basic food, fuel, and utilities, core inflation is the highest in the EU. However, we believe that the peak is close. Real wage growth dropped into negative territory from September, consumer confidence is close to a record low and a higher share of companies are complaining about a lack of demand rather than a lack of labour. These factors should tame the pricing power of companies. Thus, we see headline and core inflation peaking around the end of 2022 or early 2023. As soon as inflation starts to ease, inflation expectations will come down, so a forward-looking positive real interest rate will spur interest in the HUF.

Monetary policy: The central bank stepped into Phase 3 of its tightening cycle in mid-October with an emergency move. New temporary targeted measures were introduced to maintain financial stability alongside the main goal of price stability. The effective rate is now defined by the one-day deposit quick tender, sitting at 18%. With further fine-tuning in the system, we see monetary transmission improving, with short-end rates rising further. In parallel, tightening via the squeezing of liquidity will continue. The exit strategy from the 'whatever it takes' stance will be triggered by materially improved risk sentiment (see next bullet). We think this could translate into a gradual convergence of the effective rate to the base rate, starting as soon as late December.

Internal risks: As this policy turnaround will be triggered by a materially improved risk environment, we see a potential relief rally in the forint, despite some normalisation in interest rates. The two key elements of internal risks are the Rule-of-Law procedure and the current account imbalance. Regarding the former, we expect Hungary to settle the dispute with the EU, opening the door for EU transfers as soon as mid-December. This will eliminate a key barrier to HUF strengthening. We expect the country's external balance to improve in the coming months as the recession and coming winter will dampen the country's import needs, easing the systemic pressure on the forint. In our view, this could result in a 5% strengthening of the forint over the next six months.

EUR/CZK: Koruna under CNB control

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/CZK	24.3000	Neutral	24.50	24.50	25.00	25.00	24.50

Monetary policy: The Czech National Bank left interest rates unchanged at 7.0% for the third consecutive meeting and we think the Bank has now ended its hiking cycle - the first central bank in the region to do so. The economy already posted a decline in the third quarter of 2022 and we believe it is heading into a shallow recession. Wage growth remains high but inflation below the CNB's forecast suggests a hawkish surprise is unlikely, in our view. The current account has plunged into a record deficit and, in relative terms, we forecast it will reach the largest deficit since 2003. Moreover, fiscal policy shows only marginal signs of consolidation, and so the Czech Republic joins the twin deficit club within the CEEMEA region.

FX Interventions: The main topic for the Czech koruna in the coming months is the fate of the CNB's FX intervention regime. According to the central bank's figures, it has so far spent 16% of FX reserves from mid-May to the end of September. In our view, the CNB's activity in the markets has been zero in recent weeks, as confirmed by the Bank's board member Oldrich Dedek in a recent interview. Therefore, we see the CNB in a comfortable position and expect FX intervention to continue at least until the end of the first quarter next year with a line in the sand at 24.60-24.70 EUR/CZK.

What next? For now, the koruna is clearly capped on the upside due to the presence of the CNB in the market, while we also see the pressure on the CZK from the global environment as gradually easing. Moreover, within CEE, markets see more interesting themes in Poland and Hungary and several CZK short squeezes have discouraged bets against the end of CNB FX intervention. Therefore, we expect EUR/CZK to trade slightly below the CNB's unofficial line and the koruna will return to the market's attention in the second quarter of 2023 when we think the topic of the CNB's exit strategy will return.

EUR/RON: Focus on the 'managed' in managed float

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/RON	4.9100	Mildly Bullish	4.94	4.95	5.10	5.10	5.10

Hiking cycle: Having reached a key rate of 6.75% in November, the National Bank of Romania is either at or very close to the end of the hiking cycle. We narrowly favour no more hikes in 2023, though we admit that chances are high for another 25bp increase in January. The NBR's commitment to firm liquidity management will likely – on average – keep carry rates above the policy rate. However, we see a good chance for the liquidity situation to improve substantially into year-end on the back of accelerated spending by the Treasury. Mopping up this liquidity is likely to take a good couple of months.

Twin deficits: While on the budget deficit side, policymakers seem committed to reaching the 3.00% of GDP target in 2024 (with a 4.4% target for 2023), developments on the current account side are not encouraging. Due to unfavourable price developments in external markets (including the energy sector) but also on the back of robust GDP growth in the first half of 2022, the trade balance deficit will close well within double digits in 2022, possibly flirting with levels last touched in 2008 when it surpassed 16.0% of GDP. This represents a significant structural weakness that will keep pressure on the leu and require constant FX intervention from the central bank. Strong EU funds absorption will be key to balancing this imbalanced picture.

Politics: The relatively eventless political scene in 2022 has been rather remarkable after years of political turmoil. As per the current coalition agreement, the PNL prime minister will resign in May 2023 and a PSD prime minister should be voted in by the same coalition. While there are no real signs of trouble currently, the impending 2024 electoral year still makes it somewhat hard to picture a completely serene change of power in May-June 2023.

EUR/RSD: IMF acts as an anchor of stability

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
EUR/RSD	117.3000	Neutral	117.30	117.30	117.35	117.40	117.40

IMF: On 2 November, the IMF announced that a EUR2.4 billion 24-month Stand-By Arrangement (SBA) will replace the current Policy Coordination Instrument (PCI), subject to IMF Board approval in December 2022. The agreement will help to address "emerging external and fiscal financing needs". On the external front, the IMF estimates the current account deficit to reach 9.0% of GDP in both 2022 and 2023 due to "sharply higher energy import costs along with shortfalls in domestic electricity production, as well as weakening external demand". On the fiscal side, the initial 3.0% of GDP budget deficit target will be exceeded, most likely ending up around 4.0% of GDP. Summing up, the country needs financing, and the current choppy markets have made the IMF SBA look more appealing despite the strings attached.

Monetary policy: Beyond the proposed reforms on the fiscal side, the SBA will undoubtedly shape monetary policy as well. The 2 November press release specifically mentions that "the macroeconomic policy mix should be tight to contain high inflation and support exchange rate stability" and "the ongoing monetary tightening is crucial to ensure that inflation does not become entrenched". Essentially, we read this as a signal that the IMF is relatively comfortable with the current FX stability policy but that interest rates should continue to be increased. We revise our terminal key rate forecast from 4.50% to 5.75%, which should be reached in the first quarter of 2023.

(Geo)Politics: While on the internal front, the April 2022 elections have settled things for some time, the regional developments – be it the war in Ukraine or the Kosovo car plates dispute – are making it more and more difficult for the country to sustain the ambivalent stance it has so far maintained. Absent more clarity, Serbia's progress as a candidate country for EU accession might see little improvement in the short to medium term, which could dent its efforts to achieve the long-awaited investment grade status.

USD/KZT: A defensive play on local fundamentals

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/KZT	460.0000	Mildly Bullish	480.00	480.00	470.00	470.00	470.00

Scope for higher exports: The Kazakh tenge (KZT) depreciated 6% in the first 10 months of 2022, which is defensive given the geopolitics in the region and the 10-15% US dollar appreciation against major currencies. This is attributable to Kazakhstan's stronger trade. Exports grew 48% year-on-year in the first nine months of 2022, and the current account is back to a $7.9bn surplus vs. a $5.6bn deficit in the first nine months of 2021. Oil production of 1.5m barrels per day is below the OPEC+ quota of 1.6m bpd, and the official target of 1.9-2.0m bpd, meaning there is scope for an increase in exports in 2023,

assuming stable oil prices. Meanwhile, oilfield maintenance and an 85% dependence on Russian pipeline infrastructure are downside risk factors.

The government is looking to reduce involvement in the FX market: The government is planning fiscal consolidation to reduce the breakeven oil price from a high $110-140 in 2021-2022 to a more comfortable $55-76/bbl to 2023-25. As a result, more FX oil revenues could be saved, reducing the gross spending of the sovereign fund to $7bn in 2023 from $9-11bn in 2021-22. However, the planned 3% GDP increase in non-oil revenues appears ambitious, and the actual conversion of FX oil revenues into KZT for state spending could be higher than officially planned in the event of non-oil revenue under-collection and higher than expected spending.

Private capital flows remain uncertain: While the state capital flows, including the sovereign fund and foreign debt, are normally a mirror image of the current account, the private sector's capital flows are subject to uncertainty. In the first nine months of 2022, private outflows (including unidentified operations) narrowed to $0.3bn vs. $3.8bn in 2021, in line with our expectations, due to the post-Covid recovery in corporate borrowing and the government's capital repatriation measures. Continued capital inflows will require further progress in structural reforms, improvement in the global/regional risk appetite, and signs of a reversal in the nominal key rate trend, which is so far heading higher.

USD/UAH: Central bank allows further depreciation

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/UAH	36.8000	Neutral	40.00	40.00	38.50	37.70	37.00

Central bank: 2023 prospects for the hryvnia remain concerning. Analysts warn that the recent Russian mobilisation may prolong the conflict by at least several months. Moreover, the Ukrainian military progress may slow this winter after recent successes. This leaves the economy struggling with a massive trade deficit (US$5.4bn during the first eight months of 2023), largely reliant on international aid to shore up its FX reserves, currently at $25.2bn owing to a massive injection. However, while the scale of FX intervention has decreased markedly since its peak in July ($4bn), it remains considerable ($2bn in October). The very likely intensification of fighting in early 2023 may again push up the scale of FX intervention required to stabilise the currency. That is why we expect the central bank to allow for further depreciation of the hryvnia, possibly in the first half of 2023.

Long-term view: The prospects for the Ukrainian currency largely hinge on the timing of an end to the conflict and the ensuing inflow of reconstruction aid. Various estimates indicate that the restoration may cost up to $750bn (or nearly four times the 2021 Ukrainian GDP). A fraction of this should suffice to drive USD/UAH lower, considering the costs of Ukraine's FX intervention so far.

New normal: Returning to pre-war USD/UAH levels is impossible, though. Given the massive damage to Ukraine's infrastructure and means of production, the economy will for years remain dependent on investment-related imports. Even if those could theoretically be covered by inflows of foreign aid, the country will likely aim at maintaining a weaker hryvnia in order to support exports.

USD/TRY: No relief in sight for TRY

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/TRY	18.6000	Bullish	19.50	21.20	22.40	23.30	24.00

Central bank focus to keep financial conditions supportive: The Central Bank of Turkey (CBT) has delivered 350bp in cuts since August, pushing rates to 10.50%, while also signalling that the rate-cutting cycle will end in November at 9%. The reasoning behind the extension of the rate-cutting cycle at an accelerated pace remains the same. The CBT has cited the need for supportive financial conditions so as to preserve the growth momentum in industrial production and the positive trend in employment. Further signs of a slowdown in economic activity and the recovery in FX reserves since late July are likely factors for the cutting cycle. However, given tighter regulations on the asset side which selectively limit loan growth, cuts are not easing financial conditions quickly.

Supportive fiscal stance and continuation of selective credit policy: The timing of the recently announced Credit Guarantee Fund package (reportedly at least TRY50bn) and any possible easing in macro-prudential regulations could reverse the recent momentum loss in lending ahead of elections, with the objective of further supporting domestic demand. Policymakers are also leaning towards a more expansionary stance on the fiscal side as the budget deficit, estimated in the Medium Term Program at 3.4% of GDP in 2022, has been rapidly increasing from c.1.4% in September. The budget deficit forecast for 2023 is 43% higher than this year's forecast. And we should not rule out a breach of this target as the elections approach – scheduled for June 2023.

Inflation and external imbalances remain as major concerns: While the policy mix has tilted to a more supportive stance lately, sustained disinflation is not likely unless real rates are normalised. The recent steps are not sufficient to facilitate an external rebalancing which will be determined by the evolution of energy and gold imports. In this environment, TRY is likely to remain under pressure not only because of macro fundamentals but also because of the current unsupportive global backdrop. A recovery in FX reserves will be more challenging in this environment.

USD/ZAR: Surprise fiscal outperformance

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/ZAR	17.2000	Mildly Bearish	18.00	17.50	17.25	17.00	16.50

Some good fiscal news: For many years, the fiscal position has been the rand's Achilles' heel, including the high-profile downgrade to junk status of its sovereign bonds in 2017 and their removal from key bond indices in the 2017-20 period. However, the October budgetary statement in parliament projected South Africa running a fiscal surplus next year and the country's gross debt-to-GDP stabilising at lower and earlier-than-predicted levels. This has helped the sovereign five-year CDS retrace from the 360bp levels seen in late September. This suggests that if external conditions improve, the rand would be rewarded.

Terms of trade will be key: As a high beta, EM commodity exporter, the rand is also very much driven by both commodity prices and China's performance. Commodity prices and weak imports had helped South Africa's current account position switch to a strong surplus in 2021 and early 2022. Into 2023, however, the South African Reserve Bank (SARB) forecasts the terms of trade declining 17% and the current account moving back into deficit. South Africa will also be playing its part in the energy transition as it switches from coal and the hope is that the nation's electricity provider, Eskom, can find some stability if the sovereign assumes a big chunk of its debt.

The profile: It seems as though international investors have started to find value in the rand when USD/ZAR trades at 18.50. We think it could trade there again into early next year if the Fed tightens US real rates still further. Yet the global stagflation story is well flagged and into 2023 we think investors could switch to a more reflationary mindset if it looks like the Fed is preparing to cut rates later in the year. Equally, it is hard to see investors remaining as pessimistic on China for the entirety of 2023. We therefore see USD/ZAR trading back to 17.00 and possibly even 16.00 as 2023 progresses.

USD/ILS: Shekel well positioned when equities turn

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/ILS	3.4000	Bearish	3.50	3.40	3.25	3.10	3.00

Equities a key driver: 2022 has proved a strange year for the shekel in that when the Bank of Israel (BoI) finally turned hawkish, and with good reason, the shekel sold off along with the rest of the EMFX complex. Recall that for many years the BoI had been battling shekel strength with a large FX intervention campaign. Apart from widespread dollar strength, it also does seem that the shekel is very much driven by equities. Here, declines in overseas (mainly US) equities markets drive margin calls to Israeli buy-side investors and generate shekel weakness. We tentatively expect this dynamic to reverse in the second quarter of 2023.

Strong economy: The Israeli economy is expected to grow around 6% this year and 3% next year – even when the US and Europe are likely to be in a recession. Perhaps Israel should be warier of second-round inflation effects than most since the economy is operating above capacity and at full employment. However, the BoI hints that its tightening cycle might end around the 3% area and that inflation should come back into the BoI's 1-3% target range by the end of 2023. The risks would seem to be skewed towards the BoI needing to tighten further.

Why we like the shekel: Israel runs a 3%+ of GDP current account surplus, has strong domestic growth and a central bank not afraid to get involved in FX markets – meaning that shekel weakness will not be particularly welcome. In our experience, USD/ILS is always at the forefront of the dollar trend and if the dollar does turn in the first half of 2023 as we expect, USD/ILS should come a lot lower. Less concern over deflation by the BoI should mean that it will be more tolerant of USD/ILS breaking below 3.00 towards the end of 2023 – which could be the surprise.

Asia FX Outlook 2023: Better positioned

This year has been tough for Asian currencies – hit by surging energy prices, the strong dollar, and in some cases central banks being a little slow to react. Their course in 2023 will again be determined by the dollar trend and also diverse local stories. We see 3-5% gains in Asian FX against the dollar in 2023, with the Korean won outperforming

Rob Carnell
Regional Head of Research, Asia- Pacific
rob.carnell@ing.com

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Markets, Beijing, China

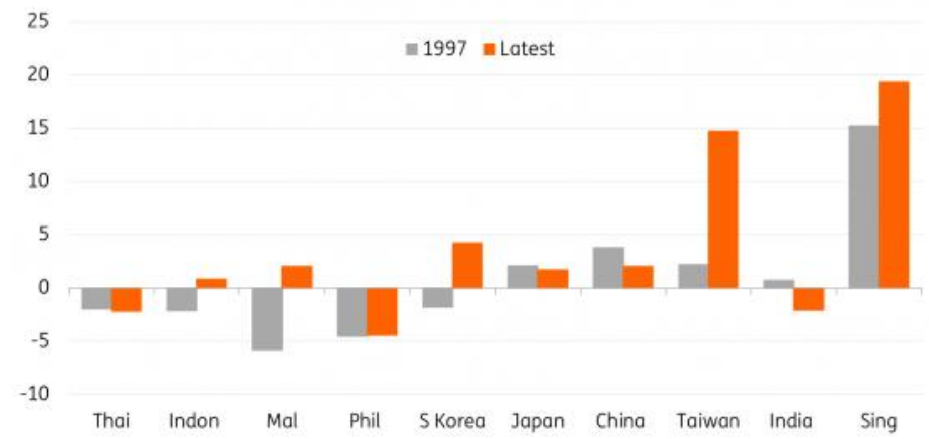
Local and international factors are still uncertain

For all the effort that goes into forecasting Asian exchange rates, the last year has shown that apart from some short-lived deviations, dollar strength was the principal driving factor and EUR/USD provided perhaps the best clue as to both direction and magnitude.

Within this period, there were times when other drivers took over – energy dependence was pivotal during the period immediately following the Russian invasion of Ukraine with the Indian rupee (INR) and Thai baht (THB) suffering badly while the Indonesian rupiah (IDR), Malaysian ringgit (MYR), and Australian dollar (AUD) outperformed. Then the differing inflation experiences, coupled with how much the respective central banks leaned against it, also held sway for a time. This saw the more interventionist economies (IDR, INR, PHP [Philippine peso]) which absorbed price pressures through fiscal buffers doing better at times compared to more market-oriented economies – such as the Korean won (KRW) – though this usually didn't last. Then there were occasions when the more managed benchmark exchange rates of the region – chiefly the Chinese yuan (CNY) – would "reset" in response to local economic conditions and drag "satellite" currencies in north Asia along with it.

In the end, though, perfect foresight of where EUR/USD was going would probably have been a better indicator than a full understanding of any of these other factors, and looking forward to 2023 we see few reasons why this should be much different over the coming 12 months.

Asian Current a/c (% GDP)



Source: Refinitiv, ING

Our house view for EUR/USD still sees some near-term dollar strength, and for this reason, we anticipate there still being some more mileage in the weaker Asian FX story. But both the scale and duration of this residual USD-driven leg remain the subject of much debate. Any further aggressive USD appreciation could see the current account surplus economies of the region outperforming their peers (see chart). External balances across the region have been damaged by this year's energy price spikes, although compared to the Asian Financial crisis in 1997, the region as a whole is still in a much healthier position with respect to external balances, FX reserves, and import cover (see also here).

At some point though, and possibly after some further Asian FX weakness, a number of factors will start to swing in the opposite direction. Local factors include:

- While still somewhat subdued, China's economy will be in better shape in 2023 than it was in 2022. There are some tentative indications of a more nuanced approach to zero-Covid, and this may be amended further following the two sessions in March.
- The property development sector will still likely be a shambles, but its drag on the economy will be trending towards zero or small positives from the substantial negative in 2022.
- Either of the factors above may free up more fiscal resources at the local government level to push growth along.
- Across the rest of Asia, without a renewed energy price spike, local inflation rates should begin to moderate, allowing for some easing of policy rates and recovery of demand.

Inflation already looks to be peaking in some economies and this trend is likely to spread. And while it may mean that policy rates can begin to be cut, the currency-relevant fact will be that negative real policy rates will shrink, and that could allow for some further currency strength.

However, when the turn comes, how much further it has gone before this occurs, and how rapidly it reverses course, will be determined by a wide range of local and international factors, and remains the subject of considerable speculation.

USD/CNY: Liquidity to remain ample

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/CNY	7.0500	Neutral	7.22	7.35	7.25	7.18	7.13

Capital flows: Even though the yuan has been weak against the dollar, we have not seen net capital outflows reflected in the data. There are several possible reasons for this. More global asset indices include China's onshore assets in their portfolios. This can smooth out volatility as the Chinese market often has low correlations with other markets. Another more likely factor is that offshore Chinese entities could be remitting dollars to their onshore counterparts and then converting them to yuan. There has also been a higher trade surplus every month so far this year. All of this adds up to a strange pattern of weak yuan mapping with net capital inflows. This pattern could continue until the People's Bank of China (PBoC) believes that there is no more risk of quick and massive capital outflows.

Macro backdrop: The Chinese economy has not been doing well in 2022 due to Covid measures, the real estate crisis, and recently, the slowdown in export demand from the US and Europe. Our GDP forecast for 2022 is only 3.3%. We believe that the Chinese government is gauging the risk to the healthcare system from re-opening by holding big events like the Beijing Marathon and Shanghai Expo. We may see some slightly more flexibility on Covid measures, but we believe that any important official announcement of Covid measures is more likely during the Two Sessions in March 2023. On real estate, more funding for local governments' 2023 budgets will be available by the end of 2022 via special bond sales. This should help local governments finish uncompleted homes faster. As such, there should be more construction activity in the first half of 2023 compared to the second half of 2022. But the risk of recession in the US and Europe will weigh on Chinese exporters and manufacturers, and therefore the jobs market. Due to the weakness of the economy, there is no inflation pressure and slight PPI deflation pressure in 2022. It is unlikely that high inflation will occur in China in 2023 given the weak economic prospects. With a low base effect and some improvements domestically, our GDP forecast for 2023 is 5.3%.

PBoC and rates: The PBoC has not changed policy interest rates since August 2022, and the time before that was in January 2022. We believe that conventional monetary policy tools, that is, policy interest rates and required reserve ratio adjustments (RRR), are not efficient to tackle existing economic conditions from Covid measures and the real estate crisis. The PBoC has turned to lending to domestic development banks that in turn lend to local governments. This gives some breathing room on fiscal pressures. And this is more efficient as there is no lag time to get funding compared to commercial loan and bond channels. It is possible that the current practice will continue until some uncompleted homes are finished and Covid measures become more flexible. Consequently, we do not expect any change in policy interest rates in 2023.

USD/INR: Real rates turn less negative

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/INR	81.1000	Neutral	83.00	84.00	83.00	82.00	82.00

Capital flows: One of the factors providing support to the INR during the past year has been the expectation that Indian Government Securities (G-Secs) would be included in one or more of the global bond indices. That expectation got knocked back in early October this year, mainly on disagreements between JP Morgan and India's Finance

Ministry on settlement issues (India wants bond trades settled locally, not at Euroclear) and taxation (India is unwilling to treat foreign bond investors differently to local investors for the purposes of capital gains). There is still some scope for inclusion in 2023, but it doesn't sound as if India's government is all that willing to make concessions. There may be more scope for equities to draw in capital in the second half of fiscal 2023, as the dry spell in IPOs is thought likely to end with around INR10.5tr reported of approved capital raising and a further INR7tr awaiting approval.

Macro backdrop: The Indian economy has not been immune to the global headwinds following Russia's invasion of Ukraine and is particularly exposed to high energy prices given its large net importer position. Despite taking advantage of some cheaper Russian crude supplies and absorbing some price pressures through margins at state-owned petroleum companies and reduced import excise duties, inflation has still risen above 7%, and this has taken its toll on the growth outlook, with third-quarter 2022 GDP coming in slower than expected, and putting previous expectations of a 7% growth rate for 2022 out of reach. We now look for growth of 6.3% in the calendar year 2022. This is still one of the highest rates of growth in Asia, and there is scope for some firming of the growth environment next year if there are no further price shocks.

RBI and rates: After abandoning its awkward dance of trying to support both growth and leaning against rising prices in early April this year, the Reserve Bank of India (RBI) has taken a steadfast and convincing stance against inflation, taking the repo rate from its low of 4.0% up to 5.9% currently. We look for a further 25bp of rate increases in December, and perhaps another 25bp in February, taking rates to 6.4%. But by then, we may well see inflation coming off its highs, which could leave the real (adjusted for actual inflation) policy rate close to zero, rather than its current strong negative rate. This could mark the peak for the RBI, as inflation should fall further from this point, enabling real policy rates to float back into positive space.

USD/IDR: Bank Indonesia to step up rate hikes

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/IDR	15,540.0000	Neutral	15850.00	15950.00	15800.00	15700.00	15600.00

Trade balance support could fade: The IDR was well supported by inflows related to trade for the most part of 2022. Exports managed to easily outpace imports this year as the export sector benefited from the surge in global commodity prices. Trade surpluses hit a record high in April ($7.5bn) but have since narrowed with the latest surplus down to $4.9bn. Slowing global trade and a dip in coal prices point to a further narrowing of the trade surplus which would impact Indonesia's current account balance. Bank Indonesia (BI) expects the current account to settle between 0.4-1.2% of GDP for 2022 but revert to a deficit in 2023. This suggests that key support for the IDR in 2022 will not be around next year resulting in sustained pressure on the currency.

Macro backdrop: Indonesia has strung together six quarters of positive growth, rebounding quickly from the pandemic-induced recession in 2021. Growth got a boost from exports, which in turn helped support the recovery of the manufacturing sector. Meanwhile, relatively subdued inflation in the first half of 2022 helped support domestic consumption with retail sales benefiting from increased mobility. Inflation, however, has finally picked up in recent months and is likely to accelerate further after the government increased the price of subsidised fuel. The recent weakness experienced by the IDR has also contributed to higher inflation, a trend that should extend to 2023. Accelerating inflation is likely to cap consumption growth in the coming quarters while

expectations for slower global trade suggest that exports will be subdued going into 2023. With the projected slowdown in the second half of 2022, we expect full-year growth to settle at 5.2% year-on-year in 2022 while 2023 growth could slip to 4.4%.

Central bank to stay hawkish: Bank Indonesia was a latecomer in terms of rate hikes in 2022 as inflation stayed relatively subdued for the first half of the year. Faster inflation by the second half of the year prodded the previously reluctant central bank to finally increase policy rates in a surprise move in August. BI has since been actively tightening, increasing rates by 75bp so far, and will likely need to continue tightening to support the IDR well into 2023. BI Governor Perry Warjiyo previously highlighted his preference for a stable currency, and we expect BI to hike rates by at least 100bp to help steady the IDR.

USD/KRW: Second half of 2023 to be better for Korea and the won

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/KRW	1,320.0000	Mildly Bearish	1350.00	1400.00	1350.00	1300.00	1250.00

Capital flows: Foreigners have been net sellers of the Korea Composite Stock Price Index (KOSPI) until recently, but we see foreign investors coming back to the Korean equity market, as the sharp outflows have stagnated over the past few months. We believe that the KOSPI will benefit from an asset allocation perspective as the China-US conflict intensifies, and thus decoupling with the Chinese market is expected to some extent. On the bond side, Korea has been added to the watch list for World Government Bond Index (WGBI) inclusion and it is possible to join the WGBI next year at the earliest. This is a positive factor providing support for the Korean won and Korean authorities appear to believe inclusion is very promising. Several new initiatives including the exemption of the withholding tax, reforms to improve accessibility to the KRW market, and Korean treasury bond (KTB) trading via ICSD (International Central Securities Depositories) were proposed to improve the structure and accessibility of its capital market for investors.

Macro backdrop: The Korean economy is heavily dependent on exports and is a net energy importer. The trade deficit will continue for some time as semiconductor exports continue to struggle while energy prices remain high. We expect the current account to be in a surplus, but weak trade performance will weigh on the currency markets.

BoK and rates: The Bank of Korea (BoK) has been one of the fastest-moving central banks in the race to raise rates since last year and is expected to become one of the fastest-moving to cut rates next year. We expect a 25bp hike in November, and perhaps another 25bp in January, taking rates to 3.50%. But the BoK is likely to go into a wait-and-see mode afterwards, as inflation is expected to slow to below 4% and fall further. To lighten the burden for businesses and households, the BoK will likely enter into an easing mode from the second half of next year.

USD/PHP: How much longer can BSP hold the line?

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/PHP	57.2000	Neutral	58.75	59.00	58.50	58.00	57.50

Current account woes to persist: The Philippines is highly dependent on imported food and energy items and has traditionally run trade deficits. Elevated global commodity prices bloated the import bill resulting in a record-wide trade shortfall. Contributing to the stark widening of the trade deficit was the economic reopening after mobility restrictions were finally relaxed in the first half of the year. Resurgent domestic demand also resulted in increased capital and consumer goods imports which were enough to

push the current account into a deficit. The trade balance and current account are likely to remain in deficit in 2023, especially if commodity prices stay elevated. The central bank expects the current account deficit to widen to roughly $19bn in 2022 and $20bn in 2023, suggesting that pressure on the PHP will persist next year.

Macro backdrop: The Philippines posted solid growth numbers in the first half of 2022 after the national government relaxed mobility restrictions after improvements in Covid-19 containment. The reopening of the economy helped along by election-related spending powered strong growth for the first half of the year (7.7%). The second half of the year, however, presents a much more challenging landscape, which also marks a change in leadership after Ferdinand Marcos Jr. won the presidential election in May. Surging inflation on top of rising borrowing costs is likely to translate to a significant slowdown in growth for the second half of 2022 and the whole of 2023. We expect inflation to hit 5.6% year-on-year in 2022 and stay elevated at 5.0% in 2023, which would translate to 5.9% YoY growth in 2022 and 4.4% in 2023.

Busy year for BSP: It has been a busy year for the Bangko Sentral ng Pilipinas (BSP). The central bank faced a quick acceleration in price pressures as well as a change in leadership after the presidential election. Given the country's dependence on imported energy and food, price pressures rose quickly to drive inflation well-past target (currently at 7.7% YoY). Several deadly typhoons also pushed up food prices after the storms caused significant crop damage. The BSP responded with several rate increases, even resorting to an off-cycle decision in July as well as a pre-announced rate increase which will take the policy rate to 5% by November. BSP Governor Felipe Medalla, who assumed his post in July, vowed to match any move by the Federal Reserve in the coming months and maintain a 100bp differential with the Fed funds target rate. We expect BSP to take the policy rate to 5.5% by year-end with at least an additional 50bp worth of rate hikes in 2023 should the Fed continue to raise rates.

USD/SGD: MAS waits for recent tightening to take hold

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/SGD	1.3700	Neutral	1.39	1.40	1.38	1.375	1.37

Growth outlook: Singapore has managed to post decent growth in 2022 despite the increasingly challenging global backdrop. Relatively robust trade activity in the first part of 2022 has helped support growth momentum although we have noted a slight deceleration of late. Meanwhile, retail sales recorded a steady pace of expansion despite the sharp uptick in prices. One possible development that could be supporting retail sales is the sustained influx of foreign visitors which may be driving the consistent growth of sales for department stores and recreational goods. Retail sales growth could help offset the projected slowdown in global trade somewhat and we expect Singapore growth to settle at 3.5% YoY in 2023.

GST to add to inflation pressure in 2023: Surging global commodity prices and robust domestic demand resulted in faster price increases for Singapore with core inflation rising 5.3% YoY as of September. The Monetary Authority of Singapore (MAS) now expects headline inflation to settle at 6% YoY for 2022 and between 5.5-6.5% in 2023 given current developments and the scheduled increase in the Goods and Services Tax (GST) from 7% to 8% next year. Risks to the inflation outlook remain skewed to the upside, especially if commodity prices stay elevated in 2023. A prolonged period of high commodity prices should eventually evolve into additional second-round effects that would fan both headline and core inflation.

MAS tightens aggressively: The MAS has been busy over the past few months, surprising market participants by tightening unexpectedly in October 2021, the first of

five separate moves to tighten monetary policy. Given surging core inflation, MAS needed to tighten policy aggressively with two of the moves carried outside of scheduled meetings. The MAS is likely to remain hawkish given expectations that core inflation will average 3.5-4.5% YoY in 2023 and stay elevated until the second half of next year. We believe, however, that the MAS would be less aggressive in tightening should it need to act as it monitors the impact of its aggressive tightening moves.

USD/TWD: Wider differentials weigh on TWD

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/TWD	31.0000	Neutral	32.40	33.00	32.00	31.70	31.40

Capital flows: The weakness of the New Taiwan dollar (TWD) in 2022 mainly comes from net capital outflows of foreign investments in Taiwan's equity market. The net outflows year-to-date amounted to $48.2bn as of 7 November. This is a lot compared to historical data of the next biggest outflows at $15.6bn in 2021, which was itself bigger than the outflows of $15.5bn in 2008. Capital outflows from the equity market have led to a fall in foreign exchange reserves of $5.62bn. Offloading of Taiwan equities should continue in 2023 as semiconductor sales should fall further as a result of the expected recession in the US and Europe and weak demand in China.

Macro backdrop: Taiwan enjoyed strong semiconductor sales in the first half of 2022, but after this the economy turned sour when Covid hit, and then weakened further when weak demand in China led to a fall in semiconductor sales. Adding to this pressure is softer demand for smart devices in 2022. As the Taiwan economy specialises in semiconductor manufacturing and sales, it is prone to external economic conditions. Taiwan did experience some higher-than-normal inflation of around 3.5% YoY in the first half of 2022. But this was then followed by softer inflation pressure in the second half of 2022 as the economy slowed. For 2023, we believe that semiconductor sales will continue to fall as a recession in the US and Europe is likely in the first half of 2023, and China's consumption demand will remain weak due to Covid measures and the ongoing real estate crisis.

Taiwan's central bank and rates: As Taiwan has not encountered as high inflation as the US, Taiwan's central bank has raised interest rates at a much slower incremental pace than the Fed. As of November 2022, Taiwan's central bank had raised rates by just 0.5 percentage points in 2022, which is much smaller than the Fed's 3.75 percentage points. This is one of the reasons why TWD has fallen over 15% so far in 2022. If the Fed pauses its hiking in 2023, the interest rate differential should stop widening.

Latam FX Outlook 2023: Too good to be true?

Chris Turner
Global Head of Markets and Regional Head of Research, UK & CEE
chris.turner@ing.com

When putting together our Latam FX outlook this time last year, we speculated on the 'Return of the Pink Tide' or a leftward shift in local politics. That has indeed materialised in presidential elections in Colombia, Chile and Brazil. We think 2023 will be another tricky year for Latam and continue to favour Mexican peso outperformance.

Former Brazilian President Luiz Inácio Lula da Silva wins the second round of the Brazilian presidential election, Sao Paulo, Brazil - 30 Oct 2022

Real rates in focus in Brazil

The leftward shift in Latin politics in 2022 has had a mixed effect on local currency markets. The election of left-leaning presidents in both Colombia and Chile has, rightly or wrongly, been associated with heavy currency falls. The pesos of Colombia and Chile are down 15% and 5% year-to-date against the dollar. The Brazilian real on the other hand has until very recently been the darling of the EM FX world, delivering 5% nominal gains and much more when taking Brazil's attractive carry into account. The Mexican peso has also done well with a 5% year-to-date gain.

Turning first to Brazil. The independent central bank moved early and aggressively with tighter policy to contain inflation. The policy rate is now 13.75% and headline inflation has already corrected to 7% from 12% – leaving Brazil with very attractive real interest rates. The market is starting to price a 200bp easing cycle for the second half of 2023, which in theory could make Brazil's local currency bonds very attractive.

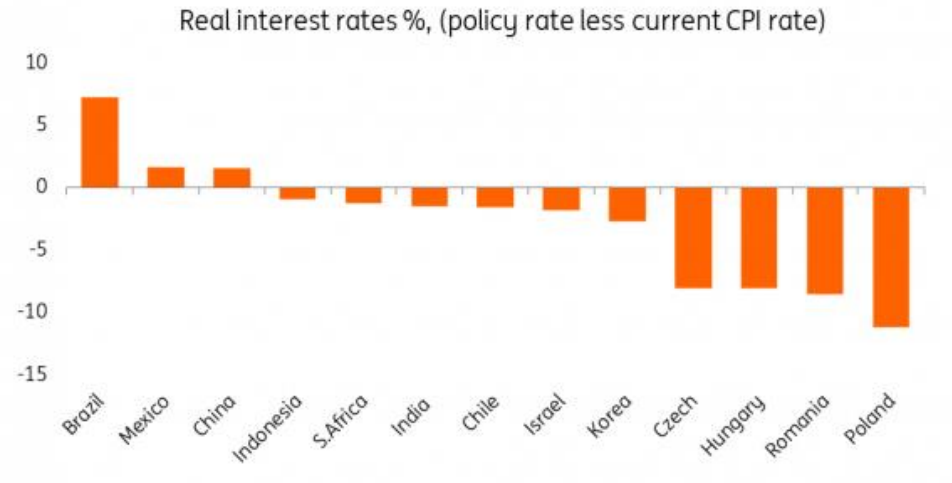
Our concern for the real, however, is that former President Lula has been re-elected on a ticket of welfare spending. Brazilian growth may sink from near-3% this year to close to zero next year. And in a difficult international environment for bond markets, fiscal pressure could see the real ending the year much weaker than the 5.15 USD/BRL levels expected by the consensus.

Chile's Achilles' heel is its large current account deficit – worth 8% of GDP this year and only expected to narrow to a 5% deficit next year. Sizable current account deficits are a distinct disadvantage at a time when core rates are rising and abundant liquidity is being withdrawn. USD/CLP will likely make another run at 1000 and despite securing an IMF Flexible Credit Line, we expect the peso to remain vulnerable – especially in early 2023 when China remains weak and the dollar strong.

Interestingly, the IMF recommends that Chile substantially restore its FX reserves – arguing that even in the good times, USD/CLP will not spend too much time below 900.

Turning finally to Mexico, we feel the peso has a lot going for it. Banxico's efforts to effectively manage USD/MXN near 20 stand to create the virtuous cycle of lower volatility and higher risk-adjusted returns. We much prefer the Mexican peso to Brazilian real exposure, given that the real trades on nearly twice the volatility as the peso. Mexico also looks much better placed in terms of debt, and its higher sovereign rating should provide some protection in the face of deteriorating external conditions. Finally, Mexico could become a major beneficiary of 'nearshoring' following recent supply chain challenges over the past three years – suggesting Foreign Direct Investment trends should be monitored carefully in 2023.

Real interest rates in Latam seem attractive...



Source: Refinitiv, ING

USD/BRL: Fiscal challenges

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/BRL	5.3000	Bullish	5.50	5.75	5.80	5.90	6.00

How fiscally aggressive can Lula be? A 'resurrection' is how President-elect Lula describes his return to office after narrowly beating the incumbent Bolsonaro in a second-round run-off. His pitch for a return to office was very much one based on welfare support and also a complete reversal of Bolsonaro's free-market approach to the Amazon. Brazilian assets initially responded positively to Lula's win in that he may be fiscally limited due to right-wing politicians having done well in congressional elections. Hence, Congress could prevent fears of unfunded social giveaways exacerbating what is likely to be an annual budget deficit of 7% of GDP and debt to GDP heading towards 90% next year.

Why we are more bearish on BRL: Consensus expects USD/BRL to head back down to the 5.15 area by the end of 2023. The view here is that inflation has topped and that Brazil's central bank can embark on a 200bp easing cycle in the second half of 2023, which should be good for the local currency bond market. We are a little more concerned that the legacy of a near 14% policy rate will be much weaker growth in Brazil next year, which will bring fiscal pressure to the fore in what will still be a challenging year for bond markets. After all, Brazil's five-year sovereign CDS trades near 280bp for a reason. Any changes in the fiscal rules would be negative.

Greater links with China?: The return of President Lula could also re-invigorate the BRICS geopolitical grouping. Where that goes in 2023 remains to be seen, although there was at some stage a suggestion of working towards some kind of BRICS currency arrangement. We doubt that Brazil would want to get entangled with such a venture, but any higher profile of the BRICS would serve as a reminder of Brazil's heavy trade links with China – 31% of Brazil's exports went to China in 2021. Sluggish Chinese growth could prove a headwind to Brazilian exports and push Brazil's current account deficit towards 2% of GDP next year.

USD/MXN: Peso enjoys high, risk-adjusted yield

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/MXN	19.4000	Neutral	20.00	20.00	19.50	19.25	19.00

High yields, less volatility: In tracking Fed tightening this year, Banxico deserves a lot of credit for keeping USD/MXN stable. Here, three-month realised volatility is just 9.9% compared to 19.3% for USD/BRL. In response, expected volatility is substantially lower for USD/MXN as well. This has implications for the 'carry-to-risk ratio' – or risk-adjusted yield which is now 50% higher for the Mexican peso versus the Brazilian real. Barring Banxico ending its tightening cycle well ahead of the Fed, we expect USD/MXN to remain relatively well-contained near or under 20.00 over the next three-to-six months even as external market conditions deteriorate.

Mexico well-placed for nearshoring: Disruptions to global supply chains from the pandemic and this year's Russian invasion of Ukraine have questioned globalisation and raised the prospects of 'friendshoring' or 'nearshoring' – i.e. moving supply chains closer to home. Mexico stands to benefit from US nearshoring, sharing as it does a land border with the US and now engaged in a new USMCA trade deal. Mexico features prominently in the White House's supply chain resilience plan, focusing on semiconductors, batteries, critical minerals, and pharmaceuticals. At $3.50/hour, Mexico's average manufacturing industry wage compares very favourably with the US ($30/hr), but also with Latin America, e.g. Brazil and Chile at $4.71 and $5.74/hr, respectively.

Remittances still rising: Remittances back to Mexico from the US are still rising and are currently worth $5bn per month. Presumably these slow at some stage when US unemployment turns higher, but they have proved remarkably resilient so far. Mexico also has a relatively modest current account deficit of less than 1% of GDP – making remittances quite meaningful. In terms of politics, it is not clear how much President Andres Manuel Lopez Obrador can get done before elections in the summer of 2024, but his fiscal rectitude during the pandemic certainly provides insulation as global borrowing costs continue to rise. Investors continue to see Mexico as a good quality credit, trading its five-year sovereign CDS at around 140bp, compared to 280bp for Brazil.

USD/CLP: Growing pains

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/CLP	885.0000	Neutral	950.00	1000.00	950.00	925.00	900.00

Controlling social tension in a recession: Left-wing President Gabriel Boric was voted into office in March 2022 on a ticket for social reform. This followed the widespread social uprising in 2019. President Boric has struggled to make progress here, with his constitutional reform package widely rejected in September – providing somewhat of a reprieve to the mining industry. 2023 stands to prove a difficult year for Chile. The IMF projects the economy will contract 1.3% next year and unemployment will rise.

Balancing how to advance social reform, while keeping the mining industry onside – softening mining taxes being a recent example – will be a major challenge.

Where's copper heading? As the largest copper producer in the world, the Chilean peso is very much driven by these prices. USD/CLP hit 1050 in July and had to seek IMF support when copper fell 25%. Our commodities team believes copper will struggle over the next six months. Incidentally, participants at the recent London Metal Exchange (LME) gathering were quite split on copper's path. Our house view is that the continued weakness in China's construction sector amidst the over-supply in the residential sector will keep copper on the back foot for the next three-to-six months. Equally, widespread labour unrest in the industry is hitting Chile's copper production, recently running at a 16-year low.

Limited scope for FX intervention: The exchange rate has proved a useful shock absorber for Chile's economy. The macro imbalances created by strong consumption during the pandemic – leaving Chile with an 8% of GDP current account deficit – make the peso vulnerable to the international environment. Chile has lost 17% of its FX reserves in defence of the peso this year. And whilst it does have the precautionary support of an $18bn IMF Flexible Credit Line, it will not want to use it. A strong dollar environment into year-end and potentially through 1Q23 can see USD/CLP head back to 1000 and perhaps also drag the local central bank into some further tightening. Interestingly, the IMF has also said that Chile needs to rebuild FX reserves, suggesting USD/CLP struggles to trade under 900 on a sustained basis over the next couple of years.

Disclaimer