PICTET WEALTH MANAGEMENT

Currencies: Outlook 2023

A volatile end to US dollar outperformance

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FLASH NOTE

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SUMMARY

- The US dollar is likely coming off a major peak, suggesting a decline in 2023 (12-month projection at USD1.10 per euro). But we see scope for a rebound in the US dollar in the next few months (three-month projection at USD1.00 per euro).
- An economic downturn in major economies coupled with central banks keeping financial conditions tight may favour defensive currencies such as the Japanese yen. Recent signs of policy normalisation in Japan could prove to be another key supportive factor, explaining our revised 12-month projection to JPY125.
- On the contrary, cyclical currencies, including EM currencies, could underperform in the first part of 2023 before outperforming when the worst of the economic slowdown has passed.

A MAJOR TURN LIKELY UNDERWAY FOR US DOLLAR

The US dollar was particularly strong in 2022, reaching extreme levels similar to previous long-term peaks (i.e. 1985 and 2021). The decline in the US dollar since early November has been mostly linked to the ‘U-turn’ in the Chinese zero-Covid policy and signs that US inflationary pressure was peaking. While the former suggests an improving global growth outlook, the latter points to a less aggressive monetary stance by the Fed and potentially a healthier global risk appetite. Such developments back our scenario of a weaker US dollar in 2023 with a 12-month projection at USD1.10 per euro.

However, we would be cautious about chasing US dollar weakness in the short term. Contrary to 1985, there is no international agreement to drive down the US dollar while a global economic downturn and tightening of financial conditions should prove supportive of the high-yielding and safe-haven US dollar. The Chinese reopening could also be disorderly, which could weigh on Chinese economic activity in the short term, while the Fed recently hammered home its (hawkish) message

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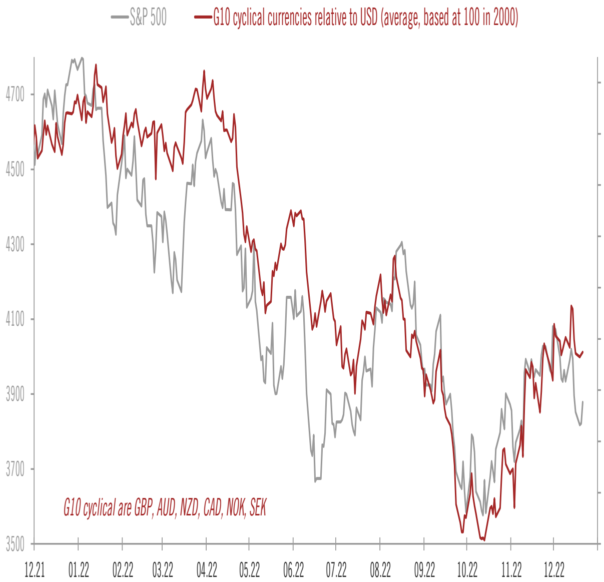
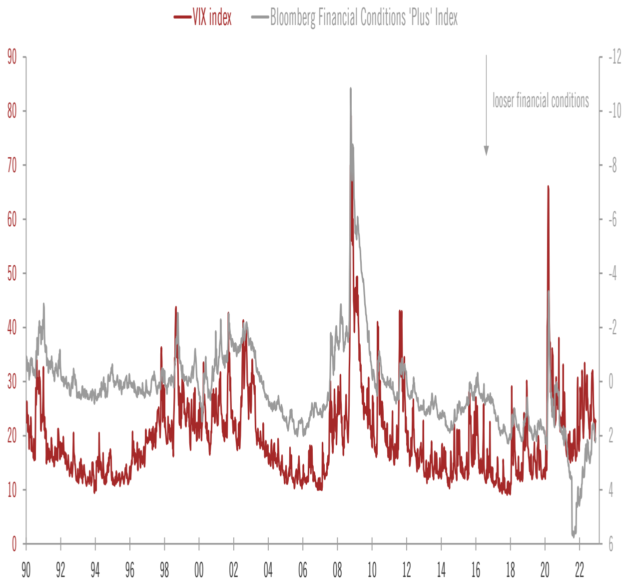
rejecting any premature loosening monetary policy (market is pricing rate cuts in H2 2023). As such, we would not be surprised to see some rebound in the US dollar in the next few months, justifying our three-month projection at USD1.00 per euro.

Chart 1: S&P 500 vs. G10 cyclical currencies



Source: Pictet Wealth Management, Refinitiv, 22 Dec. 2022

Chart 2: US financial conditions vs. VIX



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A DEFENSIVE TILT IS FAVOURED AT THE START OF 2023

While a weaker US dollar should translate into a stronger euro, the significant change in monetary policy (end of negative rates and asset purchases) coupled with limited vulnerabilities to higher rates (notably in the housing sector) compared to other economies should even favour a strong euro relative to its G10 peers. Still, the euro area dependence on energy at a time of limited availability should remain a thorn in the euro's side.

A major currency that could outperform is the Japanese yen. Historically, a US economic downturn is supportive of the yen. This is likely to remain true as weak US economic activity should cap US long-term rates and bring solace to the yen as long-term interest rate differential is a key driver. Long-term undervaluation and further steps from the Bank of Japan towards a less accommodative monetary stance are additional factors that could help the yen in 2023. In that regard, following the earlier-than-expected adjustment to the yield-curve-control framework, we have decided to revise our projections, as such developments open the door to further gradual normalisation of monetary policy. Our 12-month projection is now set at JPY125 per US dollar (vs. JPY130), while the three-month, which assumes a rebound of the US dollar, has been lowered to JPY135 from JPY144.

Similarly, the Swiss franc could perform relatively well in a weak global growth environment. In December, President Thomas Jordan said that the Swiss National Bank (SNB) had sold FX in the past months to strengthen the franc and reaffirmed its readiness to intervene further if it were to weaken. As the SNB wants to use a strong

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franc as its first line of defense against high imported price pressure, we expect the central bank to continue to target a relatively strong franc. However, with comparatively modest price increases in Switzerland, we expect the SNB to reach a lower terminal rate than other central banks and this could weigh on the franc through reduced interest rate differentials. Also, inflation differentials, which have been a key positive driver for the franc this year, will be less supportive as we move beyond peak inflation in most economies.

All in all, considering also the resilience of Switzerland's current account surplus, we continue to have a rather positive view on the franc, but we acknowledge that the upside potential of the Swiss currency could be limited. Our 12-month EUR/CHF projection stands at 0.97.

Chart 3: JPY trade-weighted index vs. US recessions

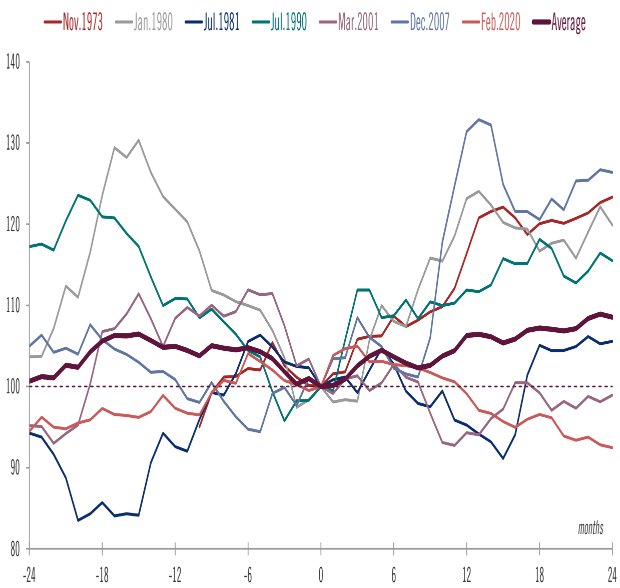

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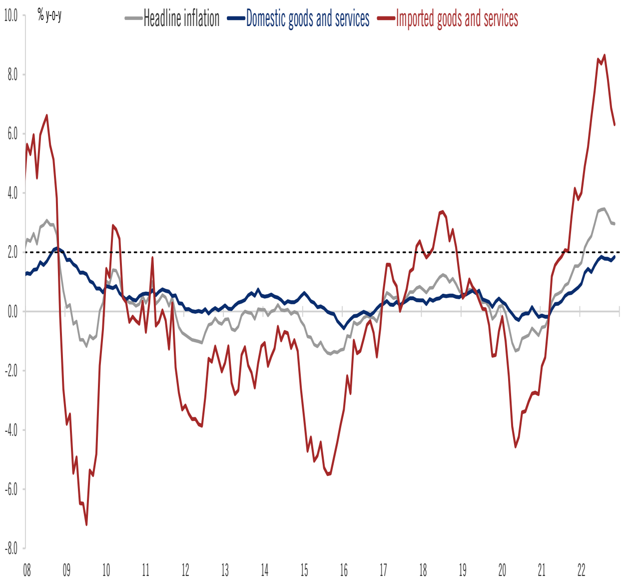
Chart 4: Switzerland inflation breakdown



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HIGH INTEREST RATES NO PANACEA FOR CYCLICAL CURRENCIES

While sterling has had a good run since the 'mini-budget' turmoil, we see limited reasons for outperformance to extend in 2023. The main drag should remain the unsupportive capital flows in the balance of payments: with the current account in deficit (UK is a net commodity importer) and FDI outflows, sterling is highly sensitive to foreign portfolio investment flows. The recent financial turmoil in the UK suggests that the housing sector may not cope with elevated interest rates, which means that sterling may have to stay weak to keep UK debt attractive to foreign investors. Furthermore, a deteriorating global risk appetite could also weigh on sterling through lower portfolio investment inflows. Our 12-month projection stands at USD1.22, while the three-month one is at USD1.13.

We have a relatively mixed view on cyclical currencies. In particular, we believe that the upside potential of most of them may be limited due to households' high level of indebtedness and their exposure to variable mortgage rates. This could weigh

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heavily on economic activity (notably in Sweden, Canada and Australia) and curtail the hawkishness of central banks. Our preference goes to oil-sensitive currencies. In particular, if energy prices move higher in 2023 as we expect, the Norwegian krone will benefit from favourable terms of trade as Norway. In the longer term, we believe that currencies of secure commodity producers will benefit from playing a part in the eventual solution for Europe's energy independence from Russia.

OPPORTUNITIES LIKELY TO ARISE IN EM CURRENCIES

Given their cyclical nature, EM currencies may also suffer should global risk appetite deteriorate. That said, we see reasons for optimism in 2023.
First, economic growth projections from major intergovernmental agencies point to a supportive differential for emerging countries relative to developed countries. Second, the reopening of China should ultimately help emerging economies, notably through higher levels of trade. Third, even if major central banks are likely to keep a tight grip on monetary conditions, a pause in the tightening cycle could put a lid on global interest rates. Assuming a rather healthy global risk appetite, investors may look for high-yielding assets in EM markets. Finally, a lower US dollar would be a boon to EM currencies.

Among the currencies that provide high carry with some defensive tilt, the Mexican peso and the Indonesian rupiah look attractive, even if their spot performance may be underwhelming relative to peers (i.e. the carry is expected to be the main driver of outperformance). External buffers (current account and FX reserves) are on the strong side, while debt levels are particularly low relative to peers. Should we be correct with the sequence of a more supportive environment in the latter part of the year for risky assets, undervalued and highly cyclical currencies, such as the Korean won and the Chilean peso, are likely to outperform.

Chart 5: EM: total debt breakdown (as % of GDP)

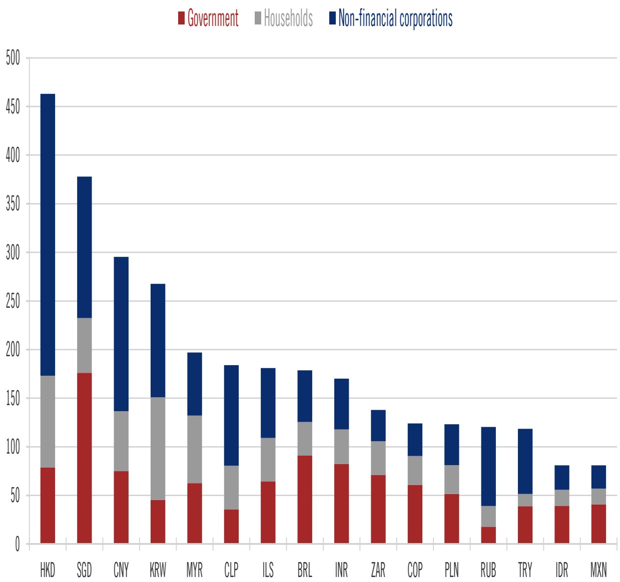

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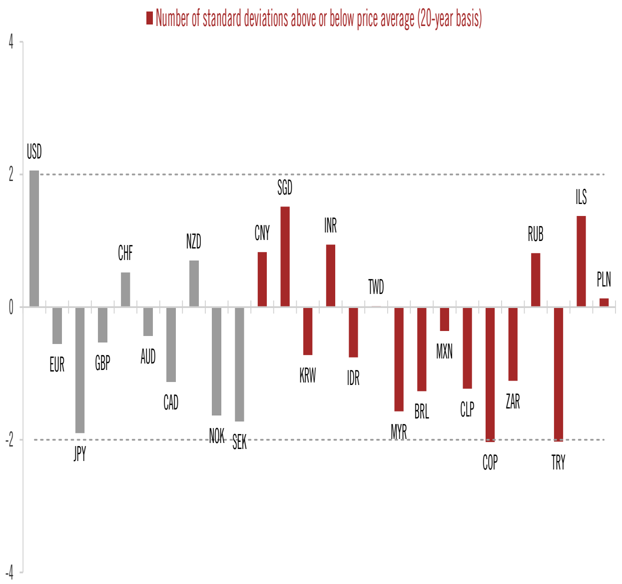
Chart 6: real effective exchange rates



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