G3 FX Forecast Revision January 2022

Written by:

Enrique Díaz-Alvarez, Matthew Ryan, Roman Ziruk & Itsaso Apezteguia

24th January 2022

Ebury

Currencies

US Dollar USD	3
Euro EUR	6
UK Pound GBP	9

ebury.com

US Dollar USD

The US dollar continued to rally against its major peers in the final quarter of last year, as financial markets ramped up bets in favour of Federal Reserve policy tightening.

The dollar has been well supported since the Federal Reserve's June meeting, which materially brought forward expectations for US interest rate hikes. Since then, FOMC officials have become increasingly more hawkish as inflation remains at very elevated levels and just shy of multi-decade highs. Continued bouts of risk aversion brought about by concerns surrounding the delta variant and rising inflation globally have further supported the greenback, and the US Dollar Index is currently trading just below its highest level in around a year (Figure 1).

Figure 1: US Dollar Index (January '21 - January '22)

Source: Refinitiv Datastream Date: 24/01/2022

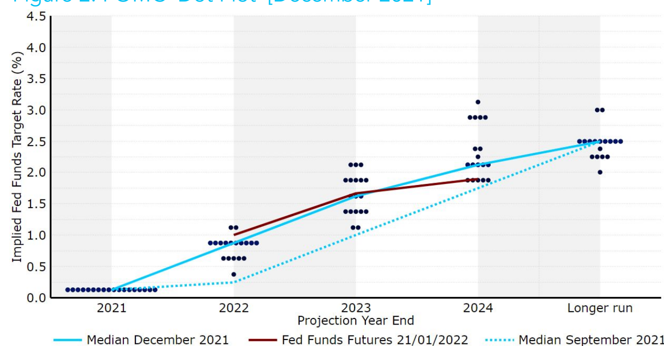
The December FOMC meeting went largely according to script. Policymakers announced that they had voted unanimously to increase the pace of QE tapering from $15 billion a month to $30 billion a month ($20 billion in Treasuries and $10 billion in MBS), effective from January.

At the current pace, asset purchases will be wound down to zero in March, a few months earlier than initially planned. The minutes of the December meeting, released in early-January, indicated that some FOMC members even believed that the bank would soon need to begin reducing its balance sheet in a process known as quantitative tightening. According to the minutes, 'the appropriate pace of balance sheet runoff would likely be faster than it was during the previous normalisation episode [in 2017]', suggesting that the process could begin at some point in 2022.

In its interest rate projections, the bank's 'dot plot', ratesetters indicated that a much faster pace of hikes was on the cards. All eighteen members now see at least one interest rate increase this year, with the median dot now showing three hikes in 2022. This was much more hawkish than expected by the market prior to the meeting. Ratesetters also now expect an additional three rate hikes during 2023 and two in 2024, which would take rates just above pre-pandemic levels over the forecast horizon. Powell's comments during the accompanying press conference were also rather upbeat. He again didn't appear overly concerned with the economic impact of omicron, stating that the US economy could handle a faster taper, even amid the spread of the variant. He also suggested that the bank was becoming increasingly concerned about inflation. The Fed officially cut the word 'transitory' in its description of price growth, with Powell warning that 'there's a real risk now that inflation may be more persistent'.

Ebury

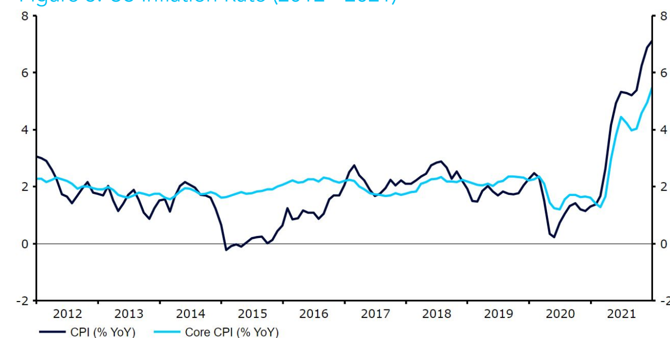
Figure 2: FOMC 'Dot Plot' [December 2021]



Source: Refinitiv Datastream Date: 24/01/2022

Following the hawkish December FOMC meeting, we have raised our expectations for Federal Reserve policy tightening. We now think that the Fed will increase interest rates for the first time in the pandemic era in March. Financial markets are also now erring towards the former, with a general consensus forming that a sooner hike is warranted given the latest surge higher in US inflation. The headline rate of consumer price growth jumped to another four decade high of 7% in December (Figure 3), well above the Fed's 2% target. Equally striking has been the rapid increase in the typically less volatile core rate of inflation, which also increased to 5.5%, its highest level since February 1991. The Fed's preferred measure of inflation, the PCE index, has also risen to a near 40-year high of 5.7%, largely a consequence of the ongoing supply-chain disruptions, rising energy costs and accommodative fiscal and monetary policies. As we have outlined in our 2022 preview report, we think that a swift return of inflation back to target levels is hard to envisage.

Figure 3: US Inflation Rate (2012 - 2021)



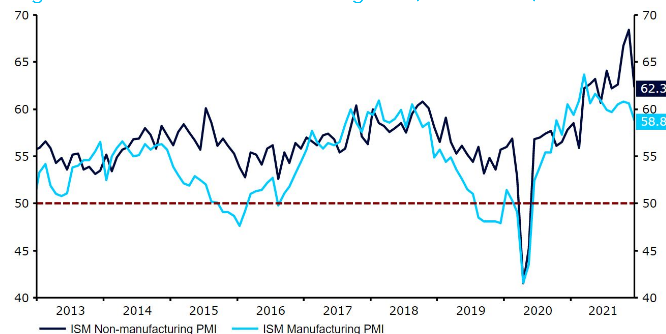
Source: Refinitiv Datastream Date: 24/01/2022

With the Fed focused on controlling inflation, the other aspect of the bank's dual mandate, full employment, will take on somewhat less importance in 2022. We believe that the US economy is already at, or near full employment, and that presents upside risks to inflation. Last year was an extraordinary one for the US labour market - an average of 537,000 net jobs were added a month, initial jobless claims fell below 190,000 for the first time in over 50 years and the unemployment rate declined to less than 4%. The headline nonfarm payrolls report for December was on the soft side at 199k, although the initial estimates throughout the past year have, on the whole, been understated, and another upward revision here is likely. Approximately 84% of the net jobs lost during the pandemic period have now been recovered, with the total number of those unemployed currently less than 10% away from pre-pandemic levels - partly a consequence of a reduction in the labour force due to early retirements. The Fed will also continue to be wary of the very high and near record levels of job openings (10.6 million in November), which should continue to pressure wages higher.

Ebury

A robust labour market has continued to support the US economy, which has been resilient to the ongoing uncertainty surrounding the pandemic. Growth slowed to an annualised pace of 2.3% in the third quarter of last year, we think partly a consequence of supply-chain disruptions. Activity data covering the final quarter of last year remained robust, notably an increase in ISM's services PMI to a fresh record high 69.1 in November (62.3 in December). Consumer spending has also performed well in the face of surging prices. Retail sales increased for the fourth straight month in November, although growth did slow to 0.2% from October's seven-month high 1.8%, and unexpectedly fell by 1.9% in December. News of an increase in wholesale inventories in Q4 has also eased concerns surrounding supply bottlenecks, and should contribute towards healthy levels of fourth quarter GDP expansion. The Atlanta Fed's GDPNow estimate suggests that growth rebounded to 5.1% annualised in the final quarter last year. A strong labour market and still accommodative fiscal and monetary policies should continue to support US expansion in 2022, albeit rising prices remain a key risk to the outlook. All in all, an economy in the midst of an inflationary boom that calls for much tighter monetary policy.

Figure 4: US ISM Non-Manufacturing PMI (2013 - 2021)



Source: Refinitiv Datastream Date: 24/01/2022

As mentioned, the US dollar has been well supported by the recent hawkish policy shift from the Federal Reserve in the past few months. We do, however, think that the dollar is now trading at rather lofty levels and that most of this aggressive rate hike cycle is already largely priced into the value of the currency. Fed fund futures are currently fully pricing in a March rate increase, and a total of 100 basis points of hikes during 2022. While we now expect four hikes from the Fed in 2022, we do not see a scenario where the FOMC raises rates more than once a quarter. In our view, the gap between market pricing for interest rates and reality is, therefore, small, and that presents limited room for additional US dollar appreciation. We have already seen evidence of this following the December CPI report, where investors sold the dollar aggressively on expectations that the fresh forty-year high inflation print would not lead to additional Federal Reserve hawkishness.

Given the above, and our generally positive view on risk sentiment and the global economy in 2022 (a US dollar negative), we continue to remain bearish on the greenback this year. We are, however, revising our near-term dollar forecasts rather sharply higher against most of its peers in order to reflect the recent appreciation in the currency. We have also upgraded our year-end projections for the USD across the board, in light of the hawkish policy shift from the Federal Reserve since our last revision.

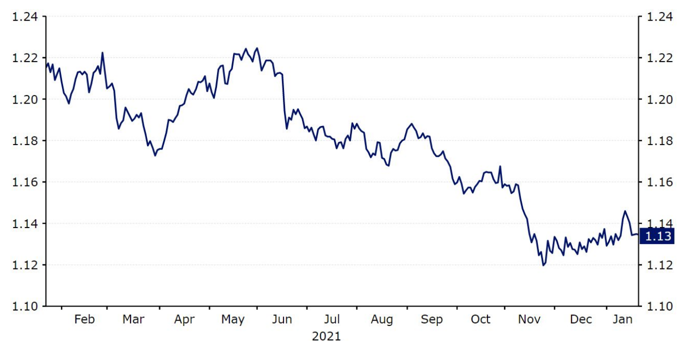
	EUR/USD	GBP/USD
Q1-2022	1.14	1.38
Q2-2022	1.15	1.40
Q3-2022	1.17	1.41
E-2022	1.19	1.42
E-2023	1.22	1.45

Euro EUR

The common currency spent December stuck within a very narrow range versus the US dollar. While the EUR/USD pair finally broke out of this range in mid-January, it has since slumped back into it (Figure 5).

Low euro volatility at the end of last year was surprising given the significance of the European Central Bank's December announcement, and the reimposition of tougher virus restrictions in much of the common bloc. European nations have, on the whole, been among the most cautious of all the major economic areas with regards to the omicron variant. A handful of countries in the European continent tightened restrictions to a significant extent either side of the New Year, and that presents somewhat of a downside risk to the Eurozone economy in the immediate-term.

Figure 5: EUR/USD (January '21 - January '22)



Source: Refinitiv Datastream Date: 24/01/2022

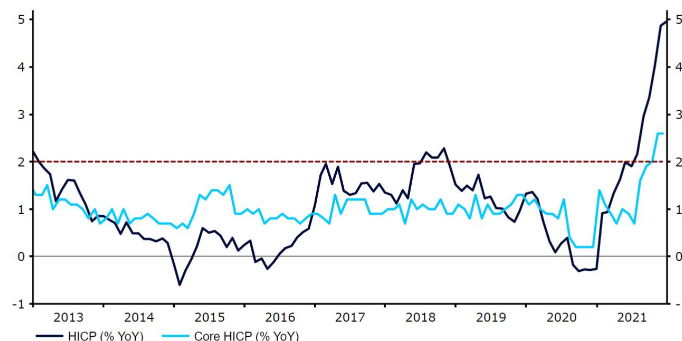
Despite the risks posed by the aggressive spread of omicron, the European Central Bank tightened policy at its 16th December meeting. In line with expectations, the ECB announced that the pace of purchases under its pandemic emergency purchase programme (PEPP) will decrease as of January, before drawing to a close at the end of March. To avoid what President Lagarde described as a 'brutal transition', policymakers announced that they will be temporarily increasing asset purchases under the 'traditional' APP. Net asset purchases will be increased by €20 billion a month to €40 billion in the second quarter, and will then be wound down to €30 in the third quarter, before returning back to €20 billion in October. In addition, the ECB made some adjustments with regards to reinvestments under PEPP, which were extended until at least the end of 2024 and can include Greek bonds (that are excluded from the APP as they are non-investment grade).

We view Lagarde's press conference in December as mixed-to-hawkish, relative to a very dovish baseline. She mentioned the continued recovery of the Eurozone economy and an improving labour market, although insisted that 'monetary accommodation is still needed'. She also touched on the worsening of the pandemic, supply bottlenecks and rising energy prices, albeit the risks to the economic outlook were still described as 'broadly balanced'. One of the more hawkish elements of her speech was the assessment that 'if price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher'. There also appears to be signs of a hawkish dissent developing among Governing Council members, with some reportedly in disagreement with the decision to extend PEPP reinvestments into 2024.

Ebury

Perhaps the most significant development in December was, however, the sharp upward revision to the ECB's inflation forecasts, particularly for 2022. The ECB now sees HICP inflation of 3.2% in 2022 and 1.8% in 2023 compared to previous forecasts of 1.7% and 1.5% respectively. So far, the ECB has been among the most dovish on both inflation and interest rates among all the major central banks. The recent signs of dissent among council members, the upwardly revised inflation projections and a continued overshoot in price growth does, however, suggest that this stance is increasingly untenable. Annual headline inflation rose again to 5% in December, its highest level on record, while the less volatile measure of core inflation has also increased to an all-time high 2.6%.

Figure 6: Euro Area Inflation Rate (2013 - 2021)

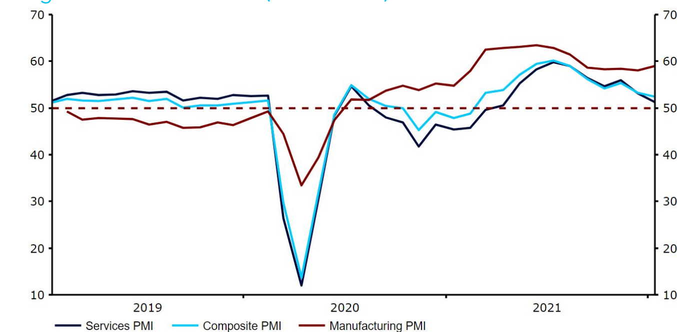


Source: Refinitiv Datastream Date: 24/01/2022

While the risks posed by omicron are likely to weigh on the Euro Area growth outlook, we think that the impact will be both temporary and minor - the restrictions reimposed so far have, in our view, been an overreaction. The Euro Area economy held up relatively well entering into the omicron period, despite the ongoing energy shortages and supply bottlenecks. The composite PMI of business activity has remained comfortably above the level of 50 denoting expansion, despite slipping to an eleven-month low 52.4 in January

Manufacturing activity has remained strong, and has been aided by tentative signs that the supply chain crisis may be easing. The ECB does, however, now expect growth to moderate this year to a downwardly revised 4.2% from the 4.6% previously anticipated.

Figure 7: Euro Area PMIs (2019 - 2022)



Source: Refinitiv Datastream Date: 24/01/2022

With only a couple of exceptions, the euro has underperformed all of its G10 peers in the past six months. This, in our view, is due to the dovish stance adopted by the European Central Bank, which is expected to lag behind most of its major peers in raising interest rates in the current hiking cycle. President Lagarde has repeatedly pushed back on market bets in favour of tighter policy, with the bank sticking by its view that above-target inflation is likely to be 'transitory' during its December communications.

We are, however, beginning to see signs that committee members are coming around to the view that price pressures are more entrenched than initially believed. ECB Vice President Luis de Guindos has been one such member, saying in mid-January that risks to inflation were 'moderately tilted to the upside' in the next twelve months, and that inflation was not going to be as transitory as believed some months prior.

Ebury

Fellow ECB ratesetter Isabel Schnabel was similarly vocal on the risks posed by rising inflation earlier this month, saying that the bank may have to act to counter the impact of rising energy prices. We think that these dissenting voices will become a growing trend among ECB members, and expect to see this hawkish faction becoming increasingly more vocal in upcoming communications.

In our view, the market is currently underestimating the chances of higher interest rates in the common bloc in 2022. We think that this provides plenty of room for a euro rally should, as we expect, the growing dissent among European Central Bank members lead to a hawkish tilt in the bank's official communications. We have, however, revised our EUR/USD forecasts higher for 2022 in order to reflect the more aggressive rate hike cycle indicated by the Federal Reserve.

	EUR/USD	EUR/GBP
Q1-2022	1.14	0.83
Q2-2022	1.15	0.82
Q3-2022	1.17	0.83
E-2022	1.19	0.84
E-2023	1.22	0.84

UK Pound GBP

As we had anticipated at the beginning of the year, sterling was one of the best performers in the G10 in 2021.

The pound ended last year higher against all of its major counterparts, aside from the Canadian and US dollars. We think that this outperformance was largely due to the UK's successful vaccine rollout, the subsequent swift removal of all virus restrictions relative to most nations, and the hawkish stance adopted by the Bank of England, which unexpectedly raised interest rates in December. Sterling also made an impressive start to 2022, rallying to a two-and-a-half month high versus the dollar in mid-January. This move was helped along by the relaxation of virus restrictions in England, and expectations that the BoE will raise interest rates again at the next MPC meeting in February.

Figure 8: GBP/USD (January '21 - January '22)

Source: Refinitiv Datastream Date: 24/01/2022

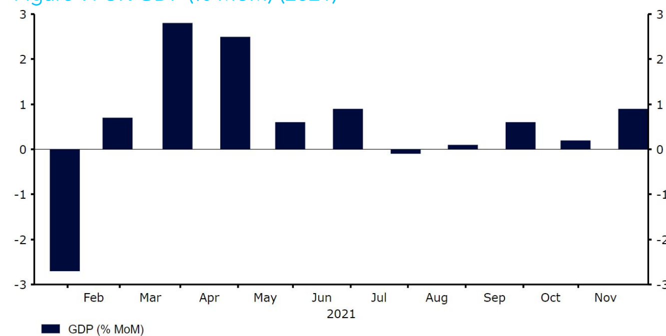
The Bank of England's communications have been rather muddled in the past few months. Policy was held steady at the November MPC meeting, despite prior hawkish remarks from Governor Andrew Bailey in October that had prepared the market for an immediate rate hike. Prior to the December meeting, communications from policymakers had turned largely dovish, with a handful of members voicing concerns over the impact of the omicron variant on the UK economy. In the end, however, the MPC surprised economists and the market by raising interest rates by 15 basis points to 0.25%. Perhaps the biggest surprise was not the decision itself, but the near unanimous nature of the vote. Eight of the nine committee members voted in favour of an immediate rate increase, with Silvana Tenreyro the only dove to support no change.

In our view, the 8-1 vote is a clear indication that policymakers are both more concerned about rising inflationary pressures than the market had originally anticipated, and less concerned about the impact of omicron on the UK economy. In its statement, the MPC noted that 'consumer price inflation in advanced economies has risen by more than expected'. UK inflation is now expected to peak at around 6% in April, three times the BoE's 2% target. While the statement did suggest that the spread of the omicron variant would weigh on growth in the first quarter of the year, we think that the impact will be rather limited, and believe that the MPC shares a similar opinion. So far, we've seen no material tightening in restrictions in England in response to the new variant, aside from tougher rules on mask wearing and working from home orders, although these measures have since been relaxed.

Ebury

We think that the relaxation of virus restrictions, and the UK's impressive rollout of booster jabs, provide a favourable outlook to growth in the near-term. So far, the UK has administered booster jabs, seen as vital in ensuring sufficient immunity against the omicron variant, to 54 people per 100, well above both the US (25) and EU (41). Indeed, activity data covering the first full month of the omicron period held up relatively well under the circumstances. The UK's composite PMI did ease to a ten-month low 53.6 in December (53.4 in January), although the drop off in activity has been minor and the index remains comfortably in expansionary territory and above pre-pandemic averages. December retail sales massively undershot expectations, although data covering the period prior to the omicron spread suggests that the UK economy entered the Christmas period on a solid footing. Growth of 0.9% in November was above expectations and the strongest pace of monthly expansion since April.

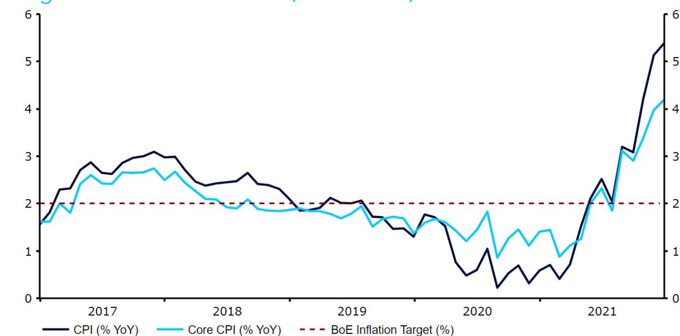
Figure 9: UK GDP (% MoM) (2021)



Source: Refinitiv Datastream Date: 24/01/2022

With omicron not expected to materially impact the UK's economic recovery, we think that an aggressive pace of interest rate hikes from the Bank of England is on the cards this year. UK inflation has continued to far outstrip the 2% target since the summer, amid a combination of the energy crunch in Europe, a tight labour market and ongoing supply-chain disruptions. The headline rate of consumer price growth jumped to 5.4% in December, comfortably above expectations yet again and its highest level since March 1992. The move higher in core inflation has been equally striking, with the typically less volatile measure increasing to 4.2% in December.

Figure 10: UK Inflation Rate (2017 - 2021)



Source: Refinitiv Datastream Date: 24/01/2022

The near-unanimous vote on rates among the MPC in December, and the continued upside surprises in UK inflation, make us increasingly confident in our call that another hike from the Bank of England is on the way at its February meeting. Futures markets are now increasingly in agreement, placing around a 90% chance of a 25 basis point move on 03/02. We think that the nature of the inflation overshoot, which has been among the largest of all the G10 economies, ensures that an aggressive hike cycle is on the way.

Ebury

We expect a total of four rate increases from the BoE this year, one a quarter, which would be among the most aggressive of all the G10 central banks. This should provide the pound with good support during the rest of 2022, albeit we do note that the already high market pricing for hikes may somewhat limit upside for the UK currency, particularly versus the euro.

	GBP/USD	GBP/EUR
Q1-2022	1.38	1.21
Q2-2022	1.40	1.22
Q3-2022	1.41	1.21
E-2022	1.42	1.19
E-2023	1.45	1.19

Ebury
100 Victoria Street, London SW1E 5JL

+44 (0) 20 3872 6670 | info@ebury.com | ebury.com

Ebury Partners UK Ltd is authorised and regulated by the Financial Conduct Authority as an Electronic Money Institution. Reference number: 900797. Ebury Partners UK Ltd is registered with the Information Commissioner's Office, with registration number: ZA345828. Ebury Partners Markets Ltd is authorised and regulated by the Financial Conduct Authority as an Investment Firm to provide advice and execute trades in FX Forwards. Reference number: 784063.

© Copyright 2009-2022