FOREIGN EXCHANGE

OUTLOOK FOR FIRST QUARTER 2022

GLOBAL LIQUIDITY TAPS ARE CLOSING

FOREIGN**EXCHANGE**

All statistical data sourced from Bloomberg, January 2022.

On September 7, 2021 State Street Corporation and BBH announced that they have entered into an agreement for State Street to acquire BBH's Investor Services business, including its custody, accounting, fund administration, global markets and technology services. Following the transaction, BBH will continue to independently own and operate its separate Private Banking and Investment Management businesses. The parties are targeting the first quarter of 2022 to complete the acquisition, subject to regulatory approvals and customary closing conditions.

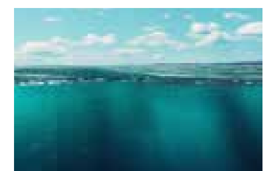
Brown Brothers Harriman & Co. ("BBH") may be used as a generic term to reference the company as a whole and/or its various subsidiaries generally. This material and any products or services may be issued or provided in multiple jurisdictions by duly authorized and regulated subsidiaries. This material is for general information and reference purposes only and does not constitute legal, tax or investment advice and is not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code, or other applicable tax regimes, or for promotion, marketing or recommendation to third parties. All information has been obtained from sources believed to be reliable, but accuracy is not guaranteed, and reliance should not be placed on the information presented. This material may not be reproduced, copied or transmitted, or any of the content disclosed to third parties, without the permission of BBH. Pursuant to information regarding the provision of applicable services or products by BBH, please note the following: Brown Brothers Harriman Fund Administration Services (Ireland) Limited and Brown Brothers Harriman Trustee Services (Ireland) Limited are regulated by the Central Bank of Ireland, Brown Brothers Harriman Investor Services Limited is authorised and regulated by the Financial Conduct Authority, Brown Brothers Harriman (Luxembourg) S.C.A. is regulated by the Commission de Surveillance du Secteur Financier. All trademarks and service marks included are the property of BBH or their respective owners. © Brown Brothers Harriman & Co. 2022. All rights reserved.

IS-07863-2022-01-11 20220059

CONTENTS

1 MAJOR MARKET GLOBAL OVERVIEW:
New Year, New Risks

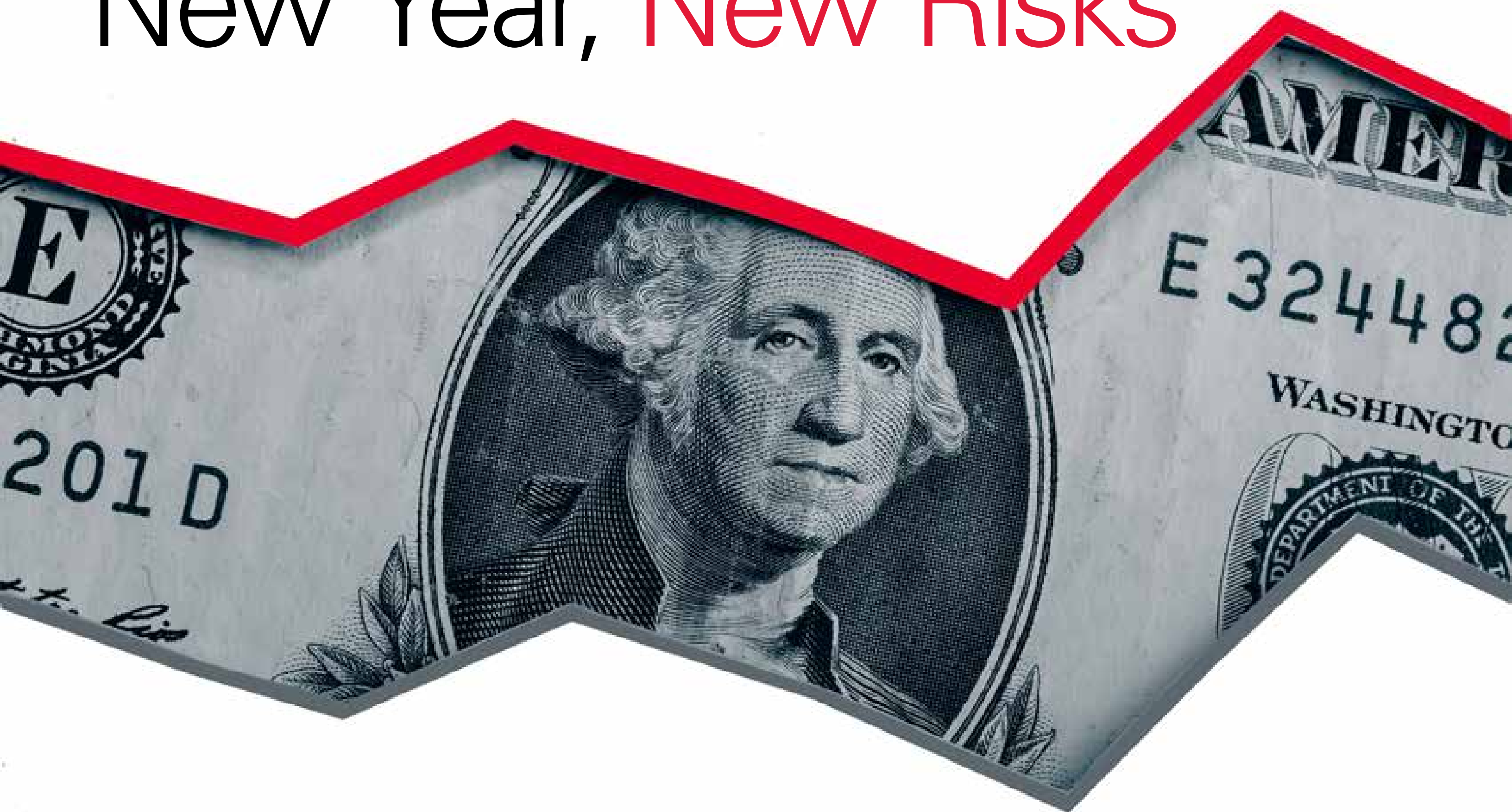
7 EMERGING MARKETS GLOBAL OVERVIEW:
Emerge or Submerge?



14 CURRENCY FORECASTS

Major Market Global Overview

New Year, New Risks



Central bank policy divergences, rising inflation, new Covid variants, and geopolitical tensions will determine whether major markets will be better or worse off in 2022.

There are many new risks that investors will face in 2022. At the root of 2021's heightened market volatility was the ongoing debate as to whether high inflation is transitory or something more lasting. In turn, this debate shaped market expectations on how central banks would react. Many of the major central banks have undergone framework reviews in recent years, making it even more difficult to determine what their new reaction functions really are. That said, investor surveys taken back in December show that a policy mistake by the Fed is the single biggest risk facing markets in 2022.

That is because one nagging question for the markets has already been answered. That is, inflation is no longer viewed as transitory and is likely to continue rising for several months still. Last year ended with heightened central bank tightening expectations and that has continued in force this year. Policy divergences were a big driver for the markets in 2021, and we expect that to continue as well as we move through 2022. However, when all is said and done, global liquidity will be removed this year at an unprecedented pace, and this will surely have significant and varied impact across all markets.

The second risk cited in surveys was that of more variants. As 2021 closed, the spread of the omicron variant was picking up. Its spread continues in 2022 but its ultimate impact on the globe remains largely unknown still. Many nations have been forced to lock down again even though this more contagious variant appears less deadly. Periodic lockdowns are likely to be seen globally in 2022 but nothing on the scale of what we witnessed in 2020. Yes, global growth will be impacted and so will some policy responses. Global growth may slow, but recession risks remain very low this year.

The third risk cited was geopolitical. Obviously, tensions remain elevated in certain areas. Russia continues to amass troops at its border with Ukraine, leading the G-7 nations to warn of serious consequences of any incursion or invasion. China continues to put pressure on Taiwan.[1] The U.S. and China appear to have reached an uneasy rapprochement for now, but this can easily be upset by China's handling of the Taiwan issue. There will of course be flareups from time to time, such as what is happening in Kazakhstan. However, most are expected to remain localized with little implications globally.

Dollar Outlook

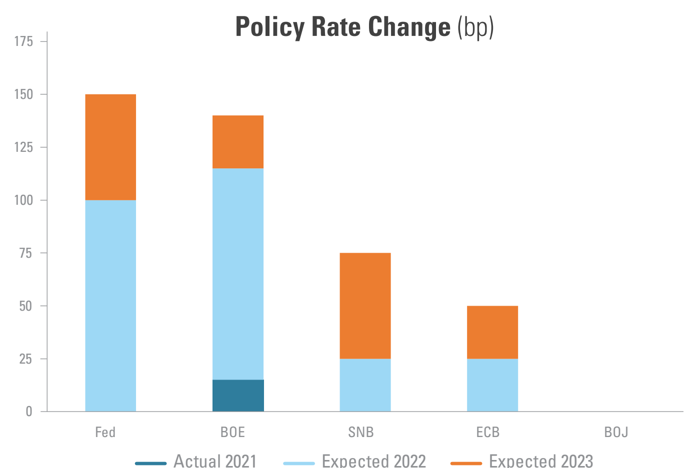
The U.S. rates market continues to adjust to the new Fed messaging and should prove dollar-supportive. The U.S. 2-year yield is trading at a new cycle high near 0.90%, while the U.S. 10-year yield is trading at a new cycle high near 1.80%. With breakeven inflation rates stable, the real 10-year yield continues to climb to around –75 bp, the highest since mid-June. All of these moves are likely to continue and should underpin our strong dollar call for 2022. Lastly, the U.S. curve steepening continues in force, with the 3-month to 10-year curve at a new cycle high near 167 bp, just short of the May 2021 high near 169 bp and the March 2021 high near 173 bp. This steepening is welcome and may help allay fears that the Fed tightening cycle will lead to a flat or even inverted yield curve. In keeping with the so-called dollar smile theory,[2] we expect the dollar to gain not only from the strong U.S. outlook, but also from periodic bouts of risk-off impulses.

Political Outlook

The political landscape will remain unsettled around the world. The U.S. will hold midterm elections in November 2022, where the entire House and one third of the Senate will be up for grabs. It's well-known that the party of the incumbent president typically does poorly in the midterms, but times are anything but typical. The Republicans face a somewhat greater challenge too in that they are defending 20 Senate seats to the Democrats' 14. Elsewhere, the Republicans only need to flip five seats to take control of the House. Obviously, the midterms will determine whether President Biden is a lame duck or not for the second half of his term.

In Europe, leadership in the two largest countries is undergoing transition and others may follow. New German Chancellor Olaf Scholz represents continuity with the Merkel era. However, he must manage a three-party coalition that will undoubtedly prove unwieldly. Elsewhere, French President Emmanuel Macron faces a difficult challenge from the right. While most polls show him as the likely winner of a second term, Macron could conceivably lose in the second round to Valerie Pecresse of the Republican Party as she is enjoying a burst of support. A strong Franco-German alliance must be maintained to meet the challenges of an increasingly assertive Russia as well as possible stresses to the eurozone economy. U.K. Prime Minister Boris Johnson enters the year severely weakened by several scandals, and speculation of a leadership challenge will surely grow if there are any more missteps by his Tory government. Lastly, there are rising fears that Italian Prime Minister Mario Draghi will step aside this year to take on the largely ceremonial post of President. If so, this would likely trigger early elections and add to the regional political uncertainty.

Central Bank Roadmap



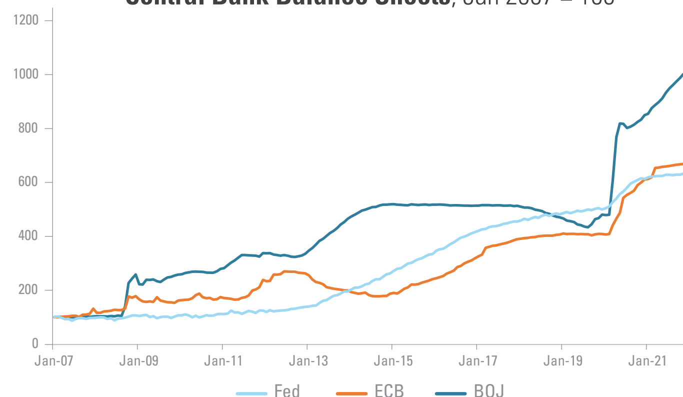
[1] Source: https://www.theguardian.com/world/2021/oct/06/why-is-china-increasing-its-military-pressure-on-taiwan
[2] Source: https://www.wsj.com/articles/what-is-the-dollars-smile-11591539293

Majors

Everything the market thought it knew about Fed policy this year was upended by the Federal Open Market Committee (FOMC) minutes. We knew the tone would be hawkish since the Fed accelerated its tapering at that December 2021 meeting. However, the minutes went above and beyond what we expected. First off, "Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated." This speaks for itself. Furthermore, the Fed is already thinking two steps ahead in discussing balance sheet runoff, as "Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate. However, participants judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate liftoff than in the Committee's previous experience." This means a much quicker timeline between rate hikes and balance sheet runoff than the last time and of course, this is dollar-positive. We thought this was a 2023 story but H2 of this year is in play for runoff.

Markets reacted as one would expect. World Interest Rate Probabilities (WIRP) now suggests nearly 90% odds of liftoff March 16 vs. 65% before the minutes, while a fourth hike this year is pretty much priced in. The nominal US 10-year yield hit a new high near 1.80%, while the real yield jumped to a new cycle high near –73 bp as the 10-year breakeven inflation rate remains stable. The U.S. 2-year yield also broke higher to a new high around 0.95% and so both US-German and US-Japan 2-year differentials are breaking up to new highs of 153 bp and 101 bp, respectively. Yet we believe the markets have some more repricing to do. The 10-year yield should move above 2% and perhaps toward 2.25%, especially with the terminal Fed Funds that is currently seen at 1.75% likely to move closer to and perhaps even above 2%. Of note, Fed Funds peaked at 2.25-2.50% back in 2019 before the mid-cycle correction saw three cuts that year to 1.50-1.75%, while the Dot Plots continue to show the median long-term rate at 2.5%.

With liftoff timing moving forward, so too should the start of balance sheet runoff. In the previous tightening cycle, the Fed waited nearly two years after the first hike before commencing balance sheet runoff. This time, it will most likely be a matter of months. While we had previously viewed Q4 2022 or Q1 2023 as most likely, it's become clear to us that the Fed is on a very accelerated timeline and will most likely halt its reinvestment phase for quantitative easing QE in early Q3. If so, this means that monetary conditions will tighten this year much more than expected and will have significant impact on risk assets that rely on cheap and abundant global liquidity, like emerging markets.



The European Central Bank (ECB) delivered a hawkish hold in December 2021. Rates were kept steady, but the bank announced that the Pandemic Emergency Purchase Programme (PEPP)[3] would end in March as scheduled. However, in an effort to minimize the shock, the ECB will boost its long-standing Asset Purchase Programme (APP)[4] to a pace of €40 billion per month in Q2 from €20 billion currently. Since PEPP purchases had been averaging about €60 billion per month, this still amounts to significant tapering of €40 billion per month. APP purchases would then fall to €30 billion per month in Q3 and then revert to €20 billion per month in Q4. The ECB said APP purchases would continue for "as long as necessary" and added that PEPP could be resumed if necessary. Unlike the Fed, however, the ECB is in no hurry to hike rates. Indeed ECB President Christine Lagarde said it was "very unlikely" that the ECB will hike rates in 2022. We agree, though the swaps market is pricing in 25 bp of tightening over the course of 2022.

ECB Forecasts from December (September)

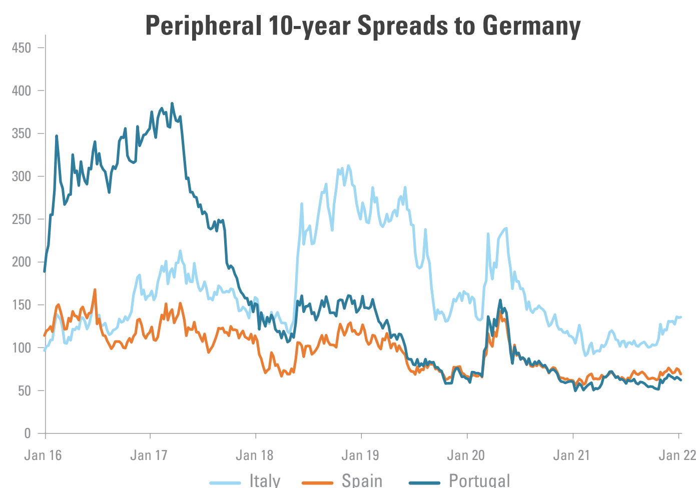
	2021	2022	2023	2024
GDP Growth	5.1% (5.0%)	5.1% (5.0%)	5.1% (5.0%)	5.1% (5.0%)
GDP Inflation	5.1% (5.0%)	5.1% (5.0%)	5.1% (5.0%)	5.1% (5.0%)

The temporary increase to its existing APP will not be large enough to prevent a significant tightening of financial conditions this year in the eurozone. Besides the impact on already shaky growth outlook, this tapering will have unwanted side effects, with peripheral spreads likely to widen further. As it is, the

[3] Source: https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.htm

[4] Source: https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html

10-year Italy-Germany differential hit a cycle high of 137 bp last month and is hovering around 132 bp currently. In a likely sign of things to come, Italy's new 30-year bond offer this month saw €43 billion of orders, less than half that for a similar sale in October 2020. Yields here have risen around 35 bp over the past month, with a similar rise seen in its 10-year paper too over the same period. Other peripheral nations such as Spain, Portugal, and Greece are likely to feel the pinch as well.



At the last Bank of Japan policy meeting January 17-18, Governor Kuroda firmly established his ultra-dovish stance. Ahead of the meeting, some unnamed official wanted to begin discussing the removal of accommodation, but that won't happen under Kuroda's watch. The bank id upgrade its long-held view that inflation risks are "skewed to the downside," a phrase that had been used since October 2014. New macro forecasts were released for that meeting and do nothing to change the existing narrative that the BOJ is on hold through FY23 at least. However, the April report will be much more important as FY24 will be added to the forecast horizon. That said, it's hard to imagine that the BOJ's core CPI forecast will rise much from the 1.1% currently forecast for both FY22 and FY23, which in turn would suggest steady rates through FY24 at least. This is the biggest reason why we remain so negative on the yen. Swaps market is pricing in no BOJ tightening over the next 12, 24, and 36 months.

BOJ Forecasts from October (July)

	FY21	FY22	FY23
GDP Growth	2.8% (3.4%)	3.8% (2.9%)	1.1% (1.3%)
Core CPI (Ex-fresh food)	0.0% (0.0%)	1.1% (0.9%)	1.1% (1.0%)

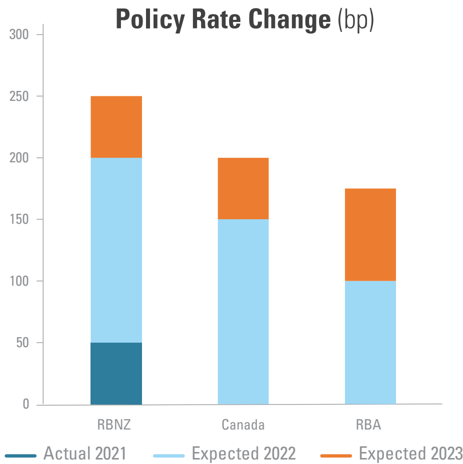
The Bank of England (BOE) started the tightening cycle in December with a 15 bp hike to 0.25%. The vote was 8-1 and the bank said it would review omicron developments at its next meeting in February. New forecasts will also be revealed then. WIRP is pricing in nearly 90% odds of a 25 bp hike in February, followed by 25 bp hikes every other meeting that takes the policy rate to 1.25% by year-end. Looking further out, the market is pricing in only one more 25 bp hike in 2023 for a terminal policy rate of 1.50%. During the year, the BOE will also start shrinking its balance sheet. According to its published plan, the bank will end its reinvestment phase when the policy rate hits 0.5% and will actively shrink its balance sheet when that rate hits 1.0%. Along with this significant monetary tightening, Chancellor Rishi Sunak will also be delivering some fiscal tightening this year even as a huge jump in the energy bill is expected to hit households in April. All of this tightening comes even as Brexit continues to be drawn out, the energy crisis persists, and COVID continues to dampen activity. Sterling has benefited from the interest rate outlook, but at some point this year, we believe the deteriorating fundamental outlook will start weighing on the currency.

Swiss National Bank (SNB) delivered a dovish hold December 16 as expected. The SNB still characterized the franc as "highly valued" and pledged to continue FX interventions as necessary. Indeed, data in early January suggest FX intervention may be picking up. Inflation has moved higher in recent months to a cycle high of 1.5% y/y in December, but the underlying message remains that the policy rate is likely to remain at –0.75% for the foreseeable future. President Thomas Jordan stressed then that inflation was still likely to ease this year. Swaps market is pricing in 25 bp of SNB tightening over the course of 2022 and another 50 bp in 2023. Given the SNB's current stance, liftoff seems unlikely before 2024. The forecasts will be updated in March and 2024 will be added to the forecast horizon, but are not expected to deviate much from the December message.

SNB Forecasts from December (September)

	2021	2022	2023
GDP Growth	3.0% (3.0%)	n/a	n/a
GDP Inflation	0.6% (0.5%)	1.0% (0.7%)	0.6% (0.6%)

Dollar Bloc



The province of Ontario is locking down as virus numbers spike from omicron. All schools will move to remote learning, while indoor dining, gyms, and movie theaters will close. Hospitals have been asked to pause all non-urgent surgeries. Retail stores will be limited to 50% capacity and indoor social gatherings will be limited to five people. While the response seems drastic compared to other countries, Premier Douglas Ford said projections show the total number of patients in hospitals would exceed capacity within a few weeks unless urgent action was taken. Local health officials acknowledged that Canada has one of the lowest number of hospital beds per capita in the developed world. Ontario is the most populous province in Canada and so these measures will have a significant impact on the national economy in Q1.

Bank of Canada tightening expectations need to adjust lower as a result. WIRP suggests a nearly 65% chance of liftoff at the next meeting January 26, which seems too aggressive in light of the developments in Ontario. Those odds rise to 100% for the March 2 meeting, which also seems too aggressive given the BOC's forward guidance for likely Q2 liftoff. All told, six hikes are priced in for 2022 that would take the policy rate up to 1.75%. Until the uncertainty regarding omicron clears, we think that such an aggressive tightening cycle is unlikely to pan out. Of note, swaps market is pricing in another 50 bp of tightening next year that would see that rate peak at 2.25% by end-2023. CAD was the only major currency to post gains against USD in 2021, but we may be in for a period of underperformance to start off 2022 if the lockdowns persist.

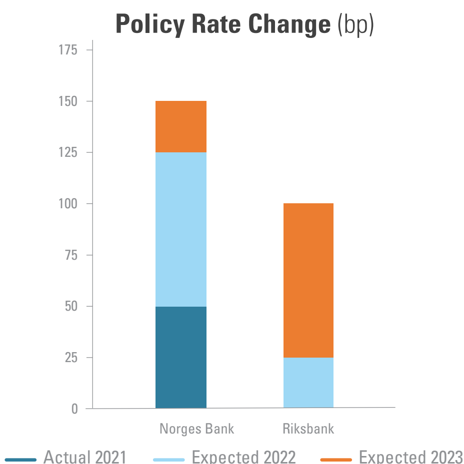
Reserve Bank of Australia (RBA) delivered a dovish hold December 7. Rates were kept steady at 0.10% and QE was maintained at the weekly pace of AUD4 billion until the next review in February. Recent data have been coming in strong as much of the nation emerged from lockdown. Of note, jobs rose 366.1k in November and pushed the unemployment rate down to 4.6%. December wasn't nearly as strong but the 64.8k jobs added still pushed the unemployment rate further down to 4.2%, the lowest since 2008. Q4 CPI surprised to the upside, with headline at 3.5% and trimmed mean at 2.6%, both multi-year highs. The RBA next meets February 1 and we think it is likely that the RBA ends its QE rather than extend it for another three months. If so, that will inevitably bring forward pricing for liftoff. WIRP suggests nearly 60% odds of liftoff May 3, while June 7 is fully priced in. With the labor market tight and price pressures rising, Q2 liftoff no longer seems far-fetched. Swaps market is pricing in 125 bp of tightening over the course of 2022, followed by another 50 bp in 2023 and 50 bp in 2024 that would take the policy rate up near 2.5%.

Reserve Bank of New Zealand continued the tightening cycle with its second 25 bp hike to 0.75% at the last meeting November 24. It started the cycle October 6 with a 25 bp hike to 0.5%. It stated that "The current Covid-19 restrictions have not materially changed the medium-term outlook for inflation and employment." Looking ahead, "The committee noted that further removal of monetary policy stimulus is expected over time." WIRP shows subsequent 25 bp hikes are fully priced in for the February, April, May, July, October, and November meetings that would take the policy rates up to 2.25% by year-end. Of note, the bank's expected rate path was just updated at the last meeting November 24 and is consistent with market pricing. Next update will come at the February meeting and should give markets a better idea of how the tightening cycle is likely to unfold in 2023 and beyond. 2025 will be added to the forecast horizon for the first time. Swaps market is pricing in another 50 bp of RBNZ tightening in 2023 that would take the policy rate up to 2.75%.

RBNZ Forecasts from November (August)

	2021	2022	2023	2024
GDP Growth	-1.4% (-2.3%)	4.5% (5.9%)	4.2% (2.4%)	1.3% (1.3%)
CPI Inflation	1.5% (1.5%)	5.7% (3.7%)	2.9% (2.2%)	2.1% (2.1%)
Rate Path (end)	0.6% (0.6%)	2.1% (1.6%)	2.6% (2.0%)	2.6% (2.1% Q3)

Scandinavia



Norges Bank hiked rates 25 bp to 0.5% December 16, as expected. The bank started the tightening cycle September 23 with a 25 bp hike to 0.25% but remained on hold in November. Inflation readings are still rising. At the last meeting, January 20, rates were kept steady at 0.50%. Governor Olsen confirmed his forward guidance from the December meeting by noting that "Based on the Committee's current assessment of the outlook and balance of risks, the policy rate will most likely be raised in March." New macro forecasts and an updated rate path won't be released until that March 24 meeting. Swaps market is pricing in 75 bp of tightening in 2022 and 25 bp in 2023 that would result in a terminal rate of 1.50% for the policy rate by end-2023, which is close to the tightening path that the bank set out in its December projections.

Norges Bank Forecasts from December (September)

	2021	2022	2023	2024
GDP Growth	4.2 (3.0%)	4.3% (3.8%)	2.5% (1.3%)	1.3% (0.9%)
CPI Inflation	3.5% (3.2%)	2.7% (1.5%)	1.5% (1.2%)	2.0% (1.9%)
Policy Rate	0.1% (0.1%)	0.8% (0.9%)	1.5% (1.4%)	1.7% (1.6%)

Riksbank delivered a hawkish hold at the last meeting November 25. Rates were kept at zero but the rate path was updated to show liftoff is expected in Q4 2024. Inflation forecasts were tweaked higher but the bank said it welcomes inflation above 2% for some time as this would help to "more clearly anchor price and wage expectations in a way that is compatible" with its inflation target. Lastly, the bank stressed that "The risks with reducing stimulation measures too early are therefore still judged to be greater than the risks of retaining them too long." Despite finally acknowledging liftoff, the Riskbank clearly stands out as one of the most dovish central banks right now and the updated forecasts suggest it will remain so for the foreseeable future. Next policy meeting is February 10 and we see no deviation from its dovish stance in 2022. Swaps market is pricing in 250 bp of Riksbank tightening over the course of 2022 and another 50 bp in 2023, which strikes us as way too aggressive.

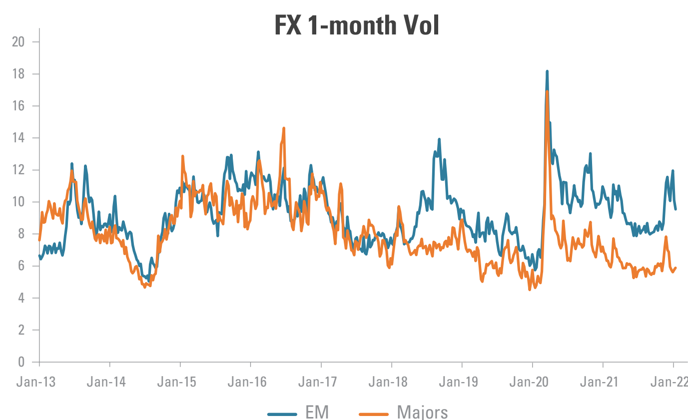
EMERGE OR SUBMERGE

As Global Liquidity Taps Tighten, How Will Emerging Markets Fare?

There is no doubt that emerging markets will face a challenging 2022. We set out the idiosyncratic risks for the major EM countries given changes in the political and economic landscape.

The global backdrop for emerging markets (EMs) is set to worsen in 2022. The main driver here is the removal of unprecedented liquidity measures by the major developed market central banks. The Fed has already started tapering and is widely expected to start hiking rates in Q2 2022. The European Central Bank is expected to begin tapering in Q2 and plans to end extraordinary quantitative easing (QE) by September, but it is unlikely to hike rates until 2023. The Bank of England, Norges Bank, and Reserve Bank of New Zealand have already started hiking rates. There is still ongoing debate as to whether the Bank of Canada and the Reserve Bank of Australia will hike rates in 2022 but it remains a real possibility. Only the Bank of Japan, Swiss National Bank, and the Swedish Riksbank are safe bets for staying accommodative into 2023.

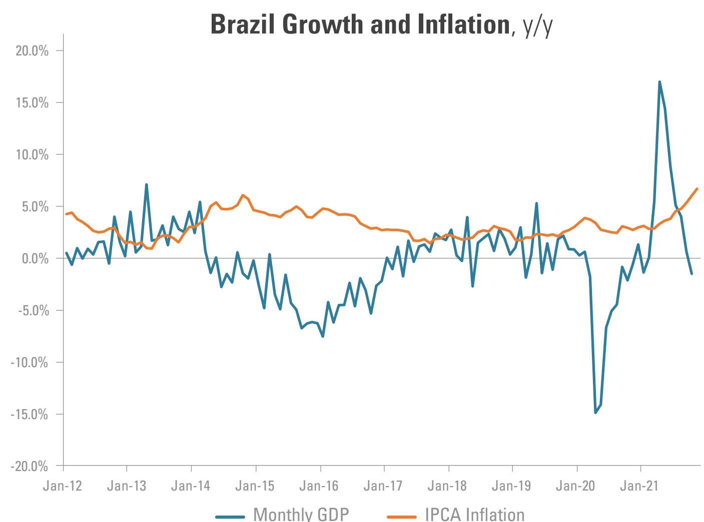
Even though many EM central banks have been hiking rates aggressively, it has not been enough to prevent local currency weakness. The return of the carry trade as a supportive favor for EM FX seems far off, as the conditions that typically foster such an environment are unlikely to be seen in 2022. Abundant global liquidity is one major factor, and we see that getting less and less abundant in 2022. A weak dollar environment is another factor, and we continue to favor a stronger dollar this year. Low EM FX volatility helps make the carry trade successful but volumes across EM currencies have been elevated and are likely to remain so. Lastly, strong global growth typically bolsters EM FX, and we see growing risks and headwinds as monetary and fiscal support are paired back as the pandemic enters its third year.



Latin America

We expect a turbulent year ahead for Brazil with an unpredictable political cycle. On the positive side, Banco Central do Brasil (BCB), continues to build a solid monetary policy buffer. It delivered the expected 150 bp hike at its last meeting in December 2021, lifting rates to 9.25% and adding hawkish overtones to the statement. The bank hinted that it's quite likely that we will see a another move of this magnitude at the next meeting February 2, 2022 though there are plenty of downside risks that could temper their hawkish enthusiasm and result in a smaller move. The swaps market is pricing in a peak policy rate of 12.50-12.75% by year-end. We expect this hawkish stance to provide some near-term support for the Brazilian real (BRL), but the medium-term outlook will still be in the hands of the economic and political cycles.

With an eye towards reelection on October 2, 2022, President Bolsonaro has already opened the fiscal spigots. Indeed, loose fiscal policy may force monetary policy to be more restrictive to offset the inflationary impulses from increased government spending. The budget deficit is forecast by the Organization for Economic Co-operation and Development (OECD) at -7.0% of GDP in 2022, up from -7.8% in 2021, while the International Monetary Fund (IMF) forecasts the current account deficit at -1.7% of GDP in 2022, up from -0.5% in 2021. The rise in the twin deficits is likely to weigh on the real, along with heightened political uncertainty. As things currently stand, former President Lula is tipped to handily beat Bolsonaro, whose popularity had dipped below the 20% mark.[1] As the economy tips into stagflation due to the tightening cycle, we expect that approval rating to decrease even more. Of note, a Lula president no longer causes the same fears in the markets as it once did, as he followed a pragmatic approach to governing and hewed to orthodox economic policy during his first two terms.

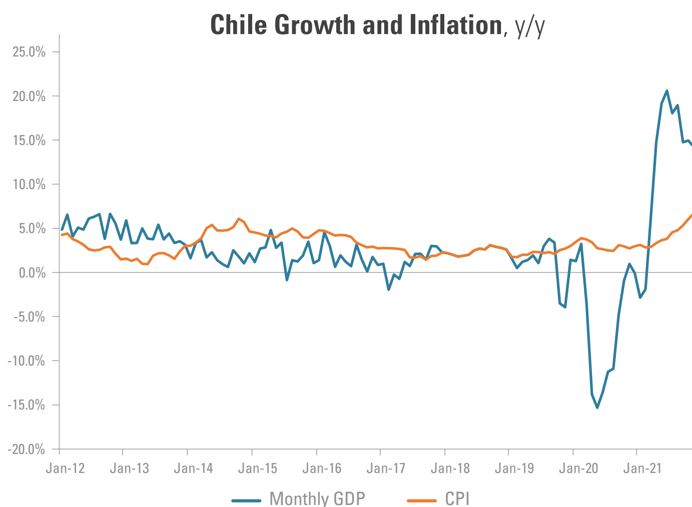


The seismic political shifts in the Andean countries are nothing short of monumental. The election of Gabriel Boric as the next president of Chile heralds a leftward lurch that has not been seen since the early 1970s under former President Salvador Allende. While the rewriting of the Constitution from the Pinochet era is long overdue, it comes at a time when investors are left wondering to what extent Chile's market-friendly environment will be maintained.

[1] Source: https://brazilian.report/liveblog/2021/11/10/bolsonaro-approval-below-20-percent-poll/

The good news is that the Chilean economy is rebounding quite smartly, helped by monetary and fiscal accommodation. Three rounds of early withdrawals from the pension system also helped, but it's not clear where Chile's current privatized system goes from here.

The outlook for Chile gets cloudier this year. As the economy booms, the central bank has embarked on an aggressive tightening cycle. Fiscal policy may fill part of the gap, as we suspect the Boric administration will boost social spending. However, Boric has already committed to fiscal responsibility and so we believe deficit spending will be limited. A fourth round of pension withdrawals was voted down in Congress, which we did not think was needed at this point in the recovery. Lastly, the outlook for copper prices is cloudy in light of the slowdown in China. When all is said and done, the political uncertainty may outweigh the strong fundamental story in Chile.



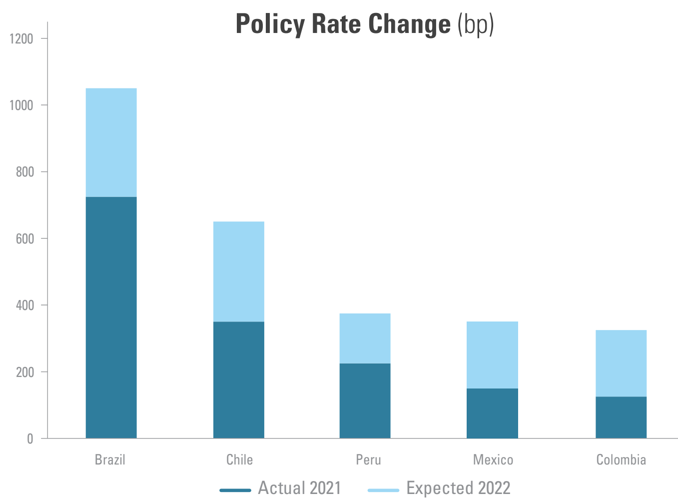
Like Chile, Peru is coming out of a turbulent political cycle and is going into a tightening cycle. The central bank delivered the expected 50 bp hike at the December meeting but the communication sounded dovish. While the door remains open for further hikes, it will not necessarily happen in consecutive meeting as the outlook still requires an accommodative stance. The bank expects inflation to fall back to the 1-3% target range in Q4 of 2022, but growth will remain below potential. Peru's policy rate of 2.5% is the lowest in the region. Many other Latin American central banks are in the midst of aggressive tightening cycles and so Peru may continue to lag in terms of policy. Peru has maintained a solid fiscal position and it seems as if the worst-case scenario under the new leftist government will not play out. That said, Pedro Castillo's government lacks a strong foothold in congress and has low public opinion, so political risks are likely to remain in play for the foreseeable future. Here too, politics may trump fundamentals in 2022.

Given the leftward shift in the other Andean nations, investors are right to be concerned about the May 2022 presidential election in Colombia. Polls suggest Gustavo Petro, a former left-wing mayor of Bogota, is the front-runner. Petro came in second in the 2018 election, losing 54-42% in the second round to Ivan Duque. Petro has continued to campaign on a populist platform that would raise taxes on the rich, increase tariffs to protect local goods, halt new oil exploration contracts to help fight climate change, and increase taxes on dividends. If no candidate wins an outright majority in May, there will be a runoff in June. Here too, risks are rising that market-friendly policies may be a thing of the past. The central bank has embarked on a tightening cycle, but as was the case for Chile and Peru, higher rates have not helped the peso much. Despite high oil prices, COP was the third worst performer in EM last year at -16%, behind only TRY (-44%), ARS (-18%), and CLP (-16.5%). PEN was close behind (-9.6%).

The Mexican government will continue to run a relatively tight fiscal operation, but there's some risk that President Andrés Manuel López Obrador (AMLO) will pursue a more radical agenda as his term runs out. The energy reform might be the main event to watch here, after it got delayed until 2022. The reform, at least in its original manifestation, would envision greater control of the electricity market for the state and less private sector participation. As always, much of what happens in Mexico depends on what happens in the U.S. economy and how aggressive the Fed turns out to be. Like Brazil, Mexico is entering a period of possible stagflation, as monthly GDP numbers have started to contract y/y.

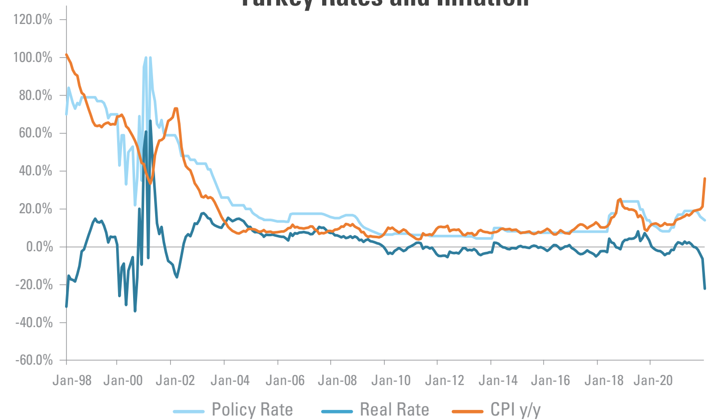
Inflation is running just under 8%, the highest since January 2001 and well above the 2-4% target range. Banco de Mexico (Banxico) delivered a hawkish surprise with a 50 bp hike to 5.50%

in December 2021. The vote was 4-1, with the dissent in favor of a smaller 25 bp move. The next policy meeting is February 10 and another 50 bp hike to 6.0% seems likely if price pressures remain high. Swaps market sees the policy rate peaking at 7.50% by end-2022 before falling slightly in 2023. This may understate Banxico's need to tighten. Banxico has a new Governor as of January 1, 2022 further complicating the outlook. Victoria Rodríguez Ceja takes the helm at a difficult time for policymaking, and she will be under the microscope. While we are withholding judgment for now, her last-minute choice by AMLO over his original candidate Arturo Herrera was controversial given her lack of monetary policymaking experience. Navigating these tricky waters would be easier with an experienced hand at the wheel.

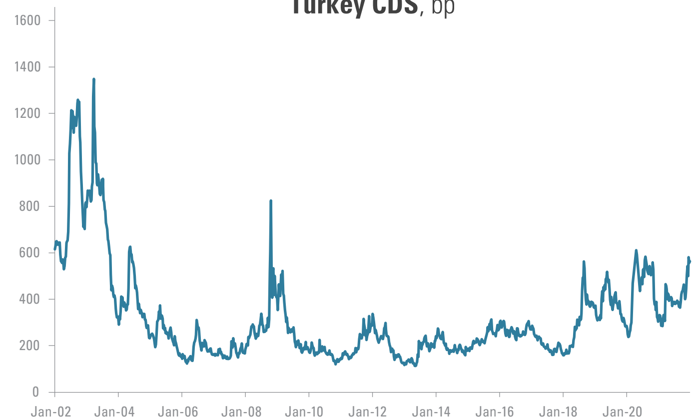


EMEA

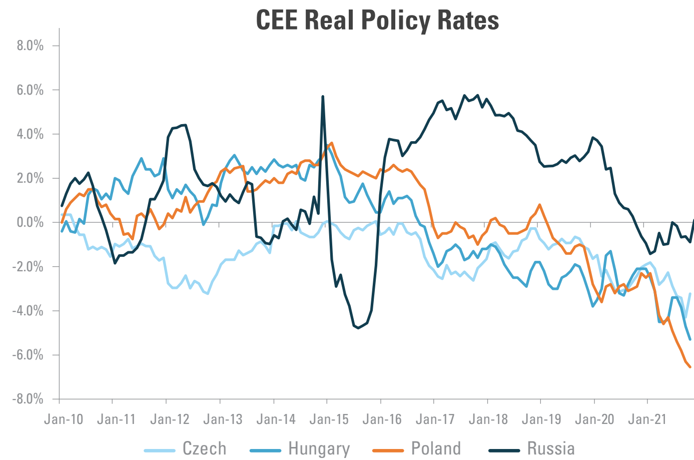
The Turkish lira is likely to remain under pressure in 2022 as inflation spirals out of control. Headline inflation surged 36.08% y/y in December 2021, nearly ten percentage points more than the expected 27.36% and well above the 21.31% posted in November. This is the highest since September 2002 and further above the 3-7% target range. What's worse, PPI surged 79.89% y/y vs. 54.62%, which portends even higher CPI readings in 2022. Rates are expected to remain steady at 14.0% for the time being after the central bank signalled an end to the easing cycle as it delivered the expected 100 bp cut to 14.0% at the December 16, 2021 meeting. Real rates remain deeply negative and so even a highly unlikely emergency rate hike of 25-30 percentage points would be unlikely to stabilize sentiment without external support from the IMF (also highly unlikely). Until that happens, the lira is likely to remain under pressure, subject to temporary bouts of strength when the central bank intervenes.



President Recep Tayyip Erdogan shows no signs of backing down from his policy gamble. He has pledged to continue cutting rates, saying "We are lowering interest rates. Don't expect anything else from me," he said. "As a Muslim, I'll continue to do what is required by nas," an Arabic word referring to Islamic teachings. However, policymakers announced a series of measures meant to help stabilize the situation in December 2021. The government will compensate holders of lira deposits if the currency loses more value than the interest rates paid by the banks. Also, policymakers will offer non-deliverable forwards (NDFs) to exporters to help them mitigate FX risks stemming from the current period of high volatility. Yet when all is said and done, these measures simply transfer FX risk from firms and individuals to the government. Without a much-needed monetary policy anchor, these measures will just balloon the budget deficit with little long-lasting impact on the currency. Despite the measures, Turkey's creditworthiness continues to deteriorate, as shown by its CDS prices.



The CEE central banks are taking varied approaches to the global spike in inflation. or the most part, this region has lagged in terms of policy responses and so their currencies are likely to underperform in 2022 until a more aggressive approach is seen. Poland and Hungary have been too timid, while Russia has been the boldest. The Czech Republic falls somewhere in between.

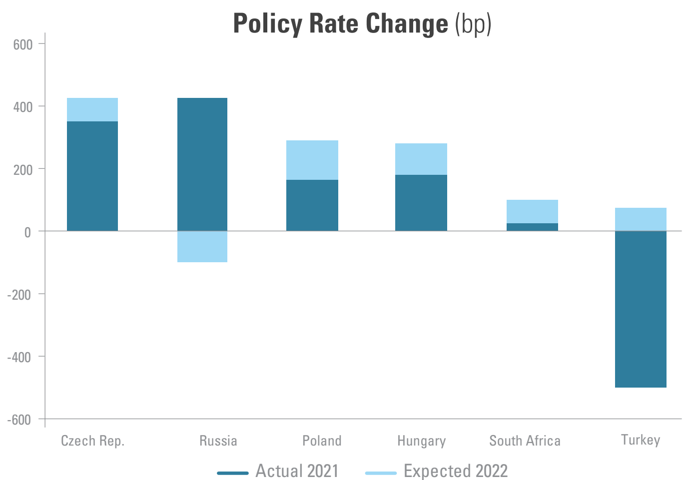


Czech National Bank has been the most aggressive and recently hiked rates 100 bp to 3.75% vs. 75 bp expected. This continued a series of a hawkish surprises, with total tightening of 350 bp in 2021. Of note, the swaps market sees a terminal rate of 3.75% in H1 before falling to 3.25-3.50% by end-2022 and then 2.50-2.75% by end-2023. We think this understates the case and that the bank will need to hike more to stabilize inflation.

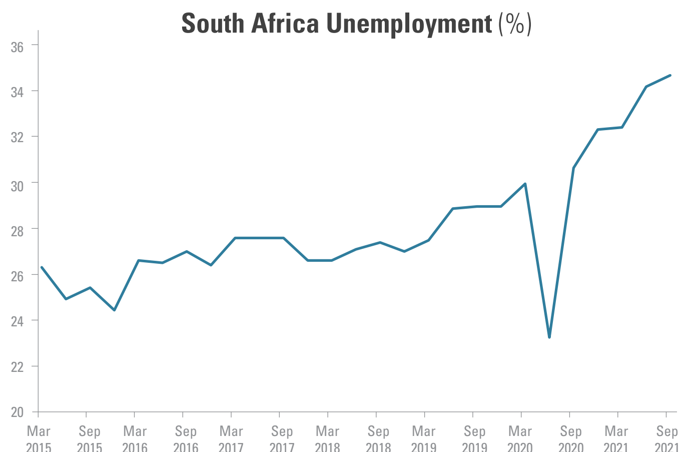
National Bank of Hungary continues to hike its 1-week deposit rate at a faster pace than the base rate. However, the bank is in danger of falling behind the curve even further. As of early January, it has hiked the 1-week rate a total of 325 bp to 4.0% go along with a total of 180 bp hikes in the benchmark rate to 2.4%. Further hikes in both rates are expected as inflation continues to rise. CPI is running just below 8% and so real policy rates are deeply negative. Prime Minister Viktor Orban faces general elections in spring 2022 and has already taken some unorthodox measures to boost his support, including a temporary freeze on floating rate mortgage rates.

National Bank of Poland recently delivered the expected 50 bp hike to 2.25%. The bank is still playing catch-up in the region after having started relatively late to the tightening game. Inflation is running just below 8% y/y so the real policy rate is still deeply negative and has a lot of room to adjust.

Central Bank of Russia recently hiked rates 100 bp to 8.5%, as expected. The bank warned that inflation risks are "markedly tilted to the upside." It said that monetary conditions remain neutral and that another rate hike is possible at one of the next meetings. Thenext policy meeting is February 11, 2022. With inflation currently running double the 4% target, another large hike then seems likely. As of this writing, the situation at the Ukrainian border remains tense but further escalation may be avoided after the Western nations put up a united front against Russia. Reports suggest that any Russian aggression will be met with significant sanctions, including such nuclear options as cutting off Russia from SWIFT and barring any investment in Russian sovereign bonds.



The initial shock from the omicron Covid variant seems to have worn off for South African assets. More evidence is emerging that the omicron variant is less severe than first thought, that vaccine boosters are effective in protecting against infection, and that while very contagious, the symptoms seem to be far milder. The South African Reserve Bank (SARB) started the tightening cycle in November 2021 with a 25 bp hike to 3.75%. Its model continues to show quarterly hikes over the course of 2022 and 2023, which we think overstates the bank's need to tighten. After all, unemployment remained high at a record 35% in Q3 2021 while the nation's growth profile remains relatively weak. On top of this, Finance Minister Enoch Godongwana is maintaining tight fiscal policy in an effort to rein in an unsustainably high and rising debt load. In the end, South Africa's problems are deeply structural, including the well understood chronic unemployment, political uncertainty, and fiscal challenges.

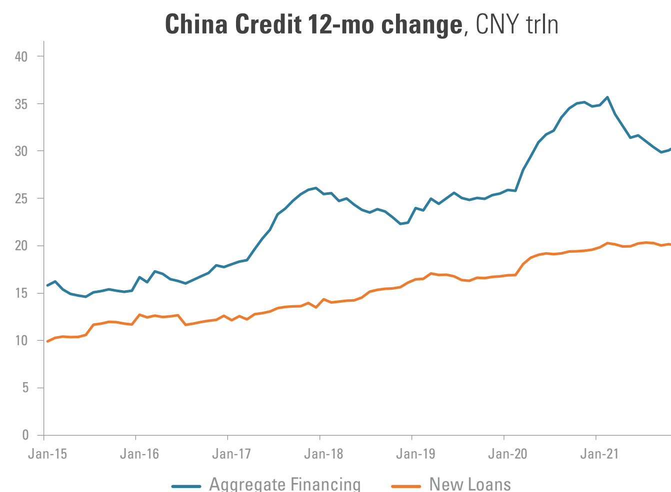


ASIA

On the monetary policy side, China has come down more firmly in favor of broad-based stimulus. Up until now, the measures have been more targeted, and include the cut in required reserves, a small cut in the 1-year Lending Prime Rate, and increased liquidity support for SMEs. The latest aggregate financing figures suggests that the authorities' efforts to stimulate the economy are materializing. This will also include further fiscal stimulus, as local governments have been encouraged to issue debt to fund infrastructure spending. These efforts will continue in 2022 as we are still near the start of this new counter-cyclical push by the government to lean against the building headwinds. These include risks from new variants, possible global slowdown, bottleneck issues, and pressure on the domestic real estate sector from troubled property developers.

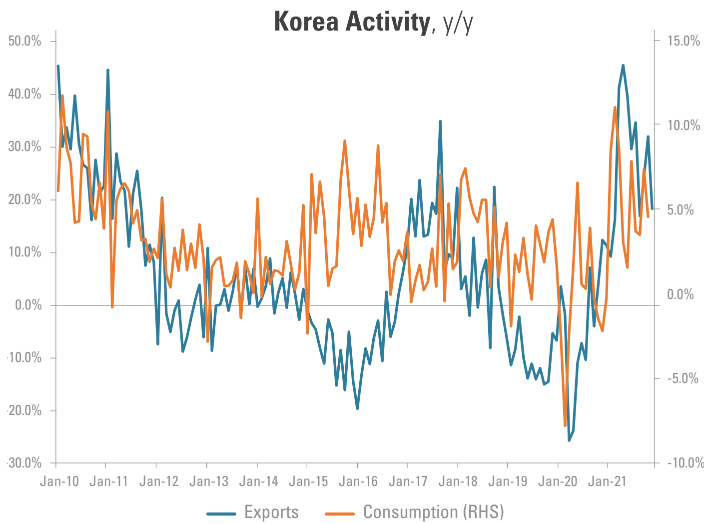
The biggest tail risk for us is if the government is unable to manage the slowdown in the property sector. There will undoubtedly be losses incurred here by investors, both domestic and foreign. However, our base case is that China muddles through. While there will be significant financial losses for investors and the sector itself, we do not see a systemic shock that threatens financial stability. When all is said and done, policymakers will always put their foot back on the gas when reform efforts start to slow growth too much. We have seen this dynamic play out time and time again.

China's policymakers are signaling concern with the strong yuan. The PBOC recently raised foreign exchange reserve requirements for its commercial banks. The move effectively removes dollars and other foreign currency from circulation and should be seen as a signal that the yuan is viewed as getting too strong. Recent daily fixes have been weaker than expected. We've been puzzled by the recent yuan gains even as broader EM FX continued to weaken and so perhaps the yuan will finally play some catch-up this year.

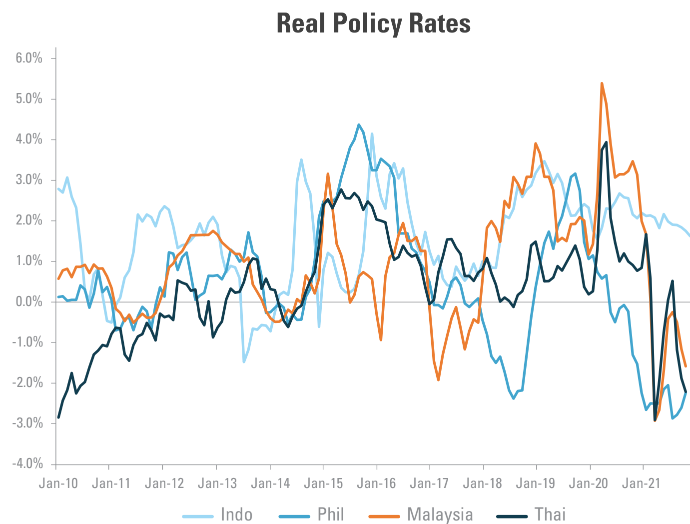


Korea stands out as the first Asian nation to tighten monetary policy. The Bank of Korea (BOK) started tightening with a 25 bp hike at the August meeting, stood pat in October, then hiked 25 bp again in both November 2021 and January 2022 to 1.25% currently. Inflation has been coming in considerably higher than expected and is running nearly double the 2% target. Most of the upside more came from higher energy prices and supply-side factors (especially food prices), but they also reflect one-off base effects from the impact of the counter-cyclical fiscal measures last year. Despite the spread of the omicron variant, we think the BOK remains on a modest hiking path and is likely to take rates higher to at least 1.50% this year, possibly more. Note, however, that despite having started the cycle well ahead of its EM Asian peers, the BOK policy rate remains well below the region's average.

Reports suggest Korea is gearing up for an expansionary budget ahead of the March 2022 presidential election. On January 21, 2022, a KRW14tr extra budget to mitigate the impact of ongoing Covid restrictions ahead of the Lunar New Year holiday. Of note, the latest polls show ruling Democratic Party candidate Lee Jae-myung leading main opposition candidate Yoon Suk-yeol by nearly 10 percentage points. The economy is firing on all cylinders right now, with both exports and domestic consumption firm.



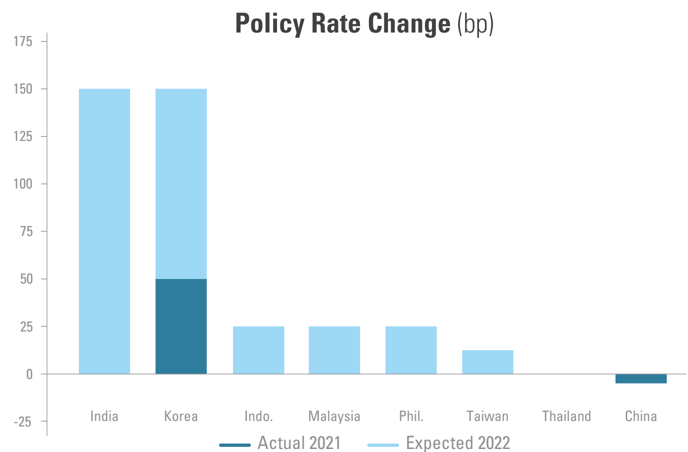
The other Asian nation that is tightening monetary policy is Singapore. At its semi-annual policy meeting in October, the Monetary Authority of Singapore (MAS) moved away from its neutral stance and tightened monetary policy by "slightly" increasing the slope of its Singapore dollar nominal effective exchange rate (S$NEER) target band, while keeping the width and center of the band unchanged. Previously, the slope was flat. The MAS said it expects the recovery to be "above-trend" in the next few quarters. The MAS thus joined the very small group of central banks in Asia that have shifted the focus from supporting growth to limiting inflation. The next scheduled policy meeting is in April 2022. While further tightening seems likely if price pressures remain high, much will depend on how omicron impacts regional activity in early 2022.



Taiwan delivered a hawkish hold in December. The central bank kept rates steady at 1.125%, as expected. However, Governor Yang Chin-long warned "'Monetary policy is moderately loose now, but it will definitely move toward tightening next year.'" He added that "The bank decided to stay on hold [at this meeting] because the economy is not overheating and there are uncertainties in the outlook." While inflation is running at the highest since February 2013, the central bank does not have an explicit inflation target and so it can be cautious and maintain its accommodative policy for the time being. Bloomberg consensus sees steady rates through H1 2022, with a 12.5 bp hike to 1.25% seen in Q3.

India is also tilting hawkish. The Reserve Bank of India abruptly halted its QE program in October 2021 and announced a series of reverse repos that would drain liquidity from the system. Price pressures have been rising in recent months. While the RBI gave no indication of starting a tightening cycle soon, swaps market sees liftoff soon followed by several hikes that would take the policy rate to 5.5% at year-end. With inflation likely to remain within the 3-6% target range, we believe market pricing overstates the RBI's propensity to tighten. Prime Minister Narendra Modi does not have to call a general election until 2024. Until then, his Bharatiya Janata Party (BJP) and its National Democratic Alliance should be able to control the legislative process with a comfortable majority in parliament. With some important state elections this year, Modi can usher through fiscal stimulus as needed.

Otherwise, virtually every other Asian central bank is maintaining an extremely accommodative stance. These include the central banks of Indonesia, Malaysia, the Philippines, and Thailand. Market pricing sees virtually no tightening by these banks over the course of 2022, with some risks of liftoff seen in Q4.



Currency Forecasts*

Major Markets

In US Dollar Terms	Current	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Euro	1.13	1.10	1.08	1.06	1.09
Yen	114	113	115	117	119
Sterling	1.35	1.33	1.31	1.31	1.32
Canadian $	1.26	1.28	1.30	1.32	1.29
Australian $	0.71	0.70	0.68	0.68	0.70
New Zealand $	0.67	0.66	0.65	0.65	0.66
Swedish Krona	8.94	9.27	9.54	9.81	9.63
Norwegian Krone	9.01	9.45	9.72	9.91	9.54
Swiss	0.91	0.93	0.96	1.00	0.95

In Euro Terms	Current	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Yen	128	124	124	124	130
Sterling	0.84	0.83	0.82	0.81	0.83
Swiss Franc	1.03	1.02	1.04	1.06	1.08
Swedish Krona	10.10	10.20	10.30	10.40	10.50
Norwegian Krone	10.18	10.40	10.50	10.50	10.40

Emerging Markets

In US Dollar Terms	Current	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Chinese Yuan	6.33	6.40	6.50	6.45	6.40
Hong Kong $	7.78	7.77	7.78	7.78	7.77
Indian Rupee	74.57	76.00	78.00	78.00	76.00
Korean Won	1196	1200	1250	1225	1200
Indonesian Rupiah	14335	14750	15000	15000	14750
Singapore Dollar	1.35	1.37	1.40	1.40	1.37
New Taiwan $	27.70	28.00	28.50	28.50	28.00
Thai Baht	33.07	34.00	35.00	36.00	34.50
Brazilian Real	5.48	5.60	5.80	5.70	5.50
Mexican Peso	20.58	21.00	22.00	21.50	21.00
Czech Koruna	21.71	22.05	22.22	22.41	21.56
Hungarian Forint	319	336	352	354	339
Polish Zloty	4.04	4.23	4.44	4.48	4.31
Russian Ruble	78.86	82.00	84.00	82.00	82.00
S. African Rand	15.28	15.50	16.00	15.75	15.50
Turkish Lira	13.41	14.00	14.50	15.00	15.50

In Euro Terms	Current	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Czech Koruna	24.52	24.25	24.00	23.75	23.50
Hungarian Forint	360	370	380	375	370
Polish Zloty	4.56	4.65	4.80	4.75	4.70

*There is no assurance that future forecasts will be attained.

DISCLOSURES

This material is provided solely for informational purposes by Brown Brothers Harriman & Co. and its subsidiaries ("BBH") to recipients who are classified as institutional or sophisticated investors, or as Professional Clients or Eligible Counterparties if in the European Economic Area ("EEA"). BBH is an independent FX research provider and this communication should not be construed as a recommendation to invest or not to invest in any country or to undertake any specific position or transaction in any currency, security, other asset class or any particular investment strategy. This material does not constitute legal, tax or investment advice. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code or for promotion, marketing or recommendation to third parties. This information has been obtained from sources believed to be reliable that are available upon request. This material does not comprise an offer of services. Any opinions expressed are subject to change without notice. Unauthorized use or distribution without the prior written permission of BBH is prohibited. This publication is approved for distribution in member states of the EEA by Brown Brothers Harriman Investor Services Limited, authorized and regulated by the Financial Conduct Authority (FCA). Please be advised that any analysis of individual countries, currencies, securities or other asset classes contained herein, including, but not limited to, rankings contained in BBH Country Risk Ratings, FX Risk Rankings and Equity Risk Rankings, should not be considered sufficient information upon which to base an investment decision. Such analysis is intended to serve as a preliminary screening tool, which should be supplemented by additional research.

This material contains "forward-looking statements" which include information relating to future events, projected future performance, statements regarding intentions, strategies, investments, expectations, the competitive and regulatory environments, predictions, and financial forecasts concerning future foreign exchange activities and results of operations and other future events or conditions based on the views and opinions of BBH. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or BBH's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. Actual results of activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors.

There are risks associated with foreign currency investing, including but not limited to the use of leverage which may accelerate the velocity of potential losses. Foreign currencies are subject to rapid price fluctuations due to adverse political, social and economic developments. These risks are greater for currencies in emerging markets than for those in more developed countries. Foreign currency transactions may not be suitable for all investors depending on their financial sophistication and investment objectives. The services of an appropriate professional should be sought in connection with such matters.

BBH, its partners and employees may own currencies discussed in this communication and/or may make purchases or sales while this communication is in circulation.

Information has been obtained from sources believed to be reliable and in good faith. Sources are available upon request. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Any opinions expressed are subject to change without notice. This material has been prepared for use by the intended recipient(s) only. Unauthorized use or distribution without the prior written permission of BBH is prohibited. Please contact your BBH representative for additional information.

BBH is a service mark of Brown Brothers Harriman & Co., registered in the United States and other countries. © Brown Brothers Harriman & Co. 2022. All rights reserved.

FOREIGN **EXCHANGE**

NEW YORK BEIJING BOSTON CHARLOTTE CHICAGO DUBLIN GRAND CAYMAN HONG KONG JERSEY CITY
KRAKÓW LONDON LUXEMBOURG NASHVILLE PHILADELPHIA TOKYO WILMINGTON ZÜRICH WWW.BBH.COM