Brown Brothers Harriman

FOREIGN EXCHANGE

OUTLOOK FOR SECOND QUARTER 2022

The Big SQUEEZE

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. We believe that regulatory reviews should be complete in the coming months.

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WHEN New Risks ARE THE SAME AS THE Old Risks

While more COVID variants and Russia's invasion of Ukraine continue to impact economies everywhere around the world, the risk of a Fed policy mistake is the latest big concern.

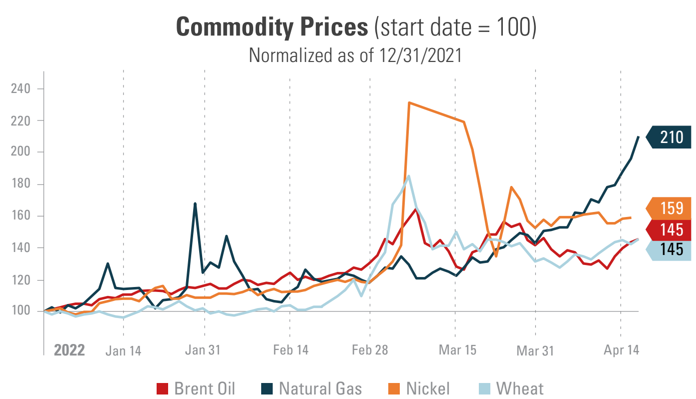
As 2021 drew to a close, global investors responded to various polls by several banks and media outlets on the biggest risks they faced in 2022. Unsurprisingly, the polls revealed the following consensus among those surveyed: 1) a Fed policy mistake, 2) a Russian invasion of Ukraine, and 3) more COVID variants. Q1 2022 quickly manifested the last two as established risks. As Q2 gets under way, the risks of a Fed policy mistake will likely move to the forefront. Before discussing that, let us first emphasize that all three risks are intertwined. For instance, the Ukraine crisis has added to Fed risks in terms of inflation, while COVID variants have added to Fed risks in terms of potential recession.

The reason for this is apparent: the invasion has led to a surge in commodity prices. In particular high food and energy prices are squeezing households everywhere around the world. In turn, that risks much slower growth and consumption ahead.

The Fed has already embarked on an aggressive tightening cycle. If anything, persistently high inflation will put the Fed under greater pressure to limit inflation and so the risks of greater than expected Fed tightening is quite real. In turn, this adds to risks that a soft-landing will turn into a hard one. And it's not just the Fed. Many other central banks have also moved forward and intensified their tightening cycles.

Elsewhere, COVID variants continue to disrupt economic activity across the globe, particularly in China. With the world's second biggest economy in hard lockdowns, there will be a significant impact on global growth in Q2.

Before moving on to discuss the Q2 landscape in greater detail, we must first identify a new risk, that of stagflation.[1] The supply side shocks emanating from Ukraine raise the risks of 1970s-style stagflation. It's still early days but if oil and other commodity prices remain elevated, we could see global stagflation. Of note, the two oil shocks of the 1970s were of greater magnitude and duration, but the current shock certainly bears watching.

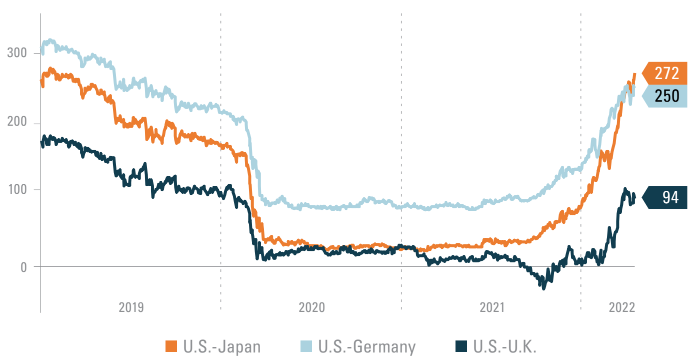


[1] https://www.businessinsider.com/stagflation?r=US&IR=T

Q2 Trends Will Be Very Similar to Q1

The dollar should continue to outperform vs. EUR, GBP, and JPY due to rising 2-year interest rate differentials. Of note, the European Central Bank just delivered a dovish hold and Bank of Japan recently reaffirmed its commitment to Yield Curve Control. The Bank of England started out its tightening cycle with a hawkish bias but has since tilted more dovish as the U.K. economy faces greater headwinds.

2-year Differentials (bp)

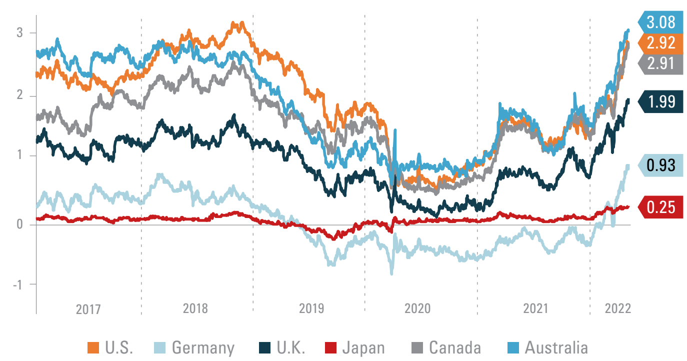


Year-to-date (YTD), the best performing majors (Australian Dollar, New Zealand Dollar, Canadian Dollar and Norwegian Kroner) are all benefiting from high commodity prices and rising local interest rates. With the Ukraine crisis showing no signs of abating, we look for commodity prices to remain elevated. With inflation risks rising, most central banks will continue tightening very aggressively in Q2.

Rising interest rates are likely to be a big headwind for global equity markets. As of this writing, the S&P 500 is -8% YTD, while the Dax is -11% YTD and the Nikkei is -6% YTD. Furthermore, COVID variants continue to disrupt economic activity across the globe, particularly in China. Here, the CSI 300 is -15% YTD. Lastly, the equity outlook is likely to remain cloudy due to greater global stagflation risks.

Global bond markets are likely to remain under pressure. In the 10-year space YTD, the U.S. yield has risen 132 bp, Germany has risen 102 bp, the U.K. has risen 92 bp, and Japan has risen 18 bp. Curve bear steepening in the U.S. is likely to continue in Q2 as the long end is expected to continue underperforming with the Fed beginning its aggressive Quantitative Tightening very soon. As the Fed continues to hike, the U.S. curve should eventually flatten as it does in a typical tightening cycle.

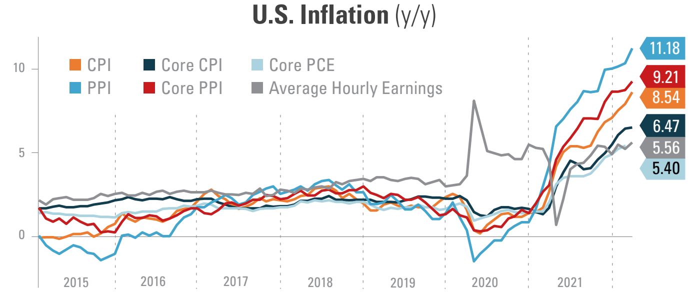
10-year Yields (%)



Behind the Curve

The U.S. economy is basically at full employment and so the Fed's primary objective now is limiting inflation. That is why recent Fed messaging has been so hawkish. In hindsight, it's easy to see that the Fed waited too long to begin removing accommodation. That said, policymakers realize this and are moving quickly to get back ahead of the curve.

U.S. Inflation (y/y)



After starting the cycle with a 25 bp move in March, the Fed is likely to hike rates 50 bp at both the May 3-4 and June 14-15 Federal

Open Market Committee (FOMC) meetings. Our call is for the Fed to quickly get the Fed Funds rate to 2.0% and then reassess the situation. That would imply another 50 bp move at the July 26-27 meeting that would take the Fed Funds target range to 1.75-2.0%. We then expect the Fed to give a hint of what it might do at the September 20-21 meeting at the Kansas City Fed's Jackson Hole Symposium in August. As things stand, we believe another 50 bp hike then is likely. Of note, swaps market is pricing in a terminal Fed Funds rate of 3.0% but we think it may have to move higher given stubbornly high inflation.

Minutes from the March 15-16 FOMC meeting suggest accelerated balance sheet runoff, or QT, could begin as soon as the May 3-4 FOMC meeting. With 100 bp of tightening expected in Q2 and perhaps another 100 bp in Q3 to go along with QT, that is a significant amount of liquidity being withdrawn by the Fed.

Trouble With the Curve

Concerns about U.S. yield curve inversion are fading, at least for now. The 3- to 10-year and 5- to 10-year portions of the U.S. curve inverted in March. The 2- to 10-year then inverted in April but all three have since turned positive as the long end of the U.S. curve has underperformed significantly. Of note, San Francisco Federal Reserve bank studies suggest that the 3-month to 10-year curve is the best at predicting U.S. recessions; at more than 200 bp, it is far from inverting. The Q1 divergence between the 3-month and 10-year curve and the 2- to 10-year curve is unprecedented and as Q2 gets under way, the strong correlation between all sectors of the curve appears to be normalizing. We believe the 10-year yield is being kept artificially low by Fed Quantitative Easing (QE); with balance sheet runoff to begin soon, U.S. curves should continue to steepen in Q2.

U.S. Yield Curve (percentage points)

No Diplomatic Solution in Sight

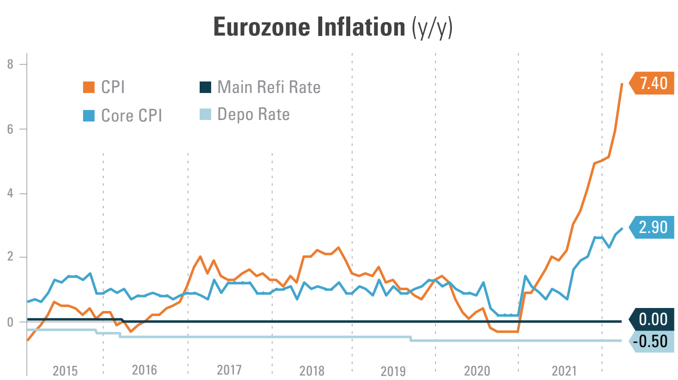
As more atrocities in Ukraine are uncovered, more sanctions on Russia are likely. Europe may even allow sanctions on Russian oil and gas exports, something it has strongly resisted up to now. The longer the conflict goes on, the longer commodity prices are likely to remain elevated and that raises the risks of global stagflation. Reports suggest the West is moving forward with a long-term strategy to isolate and weaken Russia. Gone are the days when the West sought to cooperate and coexist with Russia. Such a strategy will have long-lasting implications for the global economic order, not to mention global investors.

As things stand, Russia may be pushed into technical default after U.S. Treasury banned it from making any external debt payments via U.S. banks. Some external debt payments have already been turned away, leaving us with the highly unusual situation whereby a debtor is willing and able to service its obligations but is prevented from doing so because of international sanctions. So far, contagion to other EM countries has been very limited, with EMBI spreads continuing to narrow. Note that Russia has been dropped from most global bond indices as a result of the sanctions, which basically has made Russia un-investable.

EM Spreads (bp)

Hawks vs. Doves

Headline eurozone CPI is running at record highs, leading the European Central Bank to tilt more hawkish. The ECB accelerated QE tapering and so markets have moved forward liftoff expectations to the July 21 meeting. However, the bank pushed back against this notion at its April meeting, reaffirming its cautious timeline of ending QE in Q3 followed by a rate hike "some time" after. Madame Lagarde was even more dovish in her post-decision press conference. She identified energy is still the main reason behind high inflation but added that price rises have become more widespread. While labor demand remains robust, she sees muted wage growth overall. Of note, Lagarde said that the ECB is always attentive to FX moves but did not discuss it at this meeting.

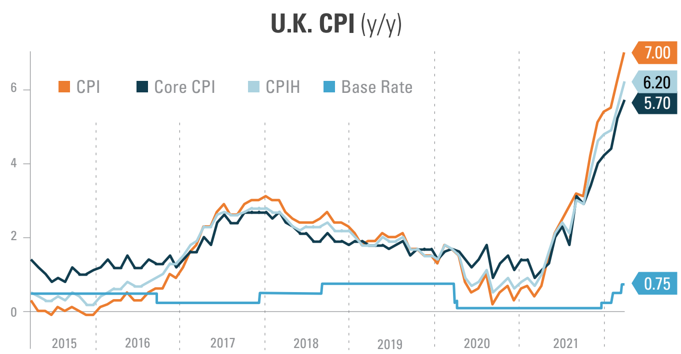


Here are the key takeaways from the dovish ECB narrative: 1) its Asset Purchase Program (APP) is likely to end in Q3 followed by likely liftoff in Q4; 2) the June 9 meeting will provide key forward guidance on the end of APP and potential liftoff, but for now, the ECB appears to be in no hurry to hike rates; 3) the weak euro does not seem to be a concern; 4) inflation is still seen as an energy issue, with wage growth remaining muted; and 5) there will be no firm commitment yet on how soon rates will be hiked after APP ends.

Eurozone political risk has ebbed after President Macron won a second term handily in the French runoff. The margin of his victory over Le Pen was 58-42%, much narrower than his 66-34% victory over Le Pen in the 2017 election. Macron becomes the first incumbent to win reelection since Chirac. However, parliamentary elections scheduled for June will be very important as Macron's coalition works to preserve its working majority in order to help advance his legislative agenda.

To Hike or Not to Hike?

Headline U.K. CPI is running at the highest in three decades. The Bank of England started the tightening cycle in December with a very hawkish tone but has since turned more dovish. A 25 bp hike to 1.0% at the next meeting on May 5 is fully priced in. Once the policy rate hits 1.0%, the bank's strategic plan calls for balance sheet runoff. Looking ahead, the swaps market sees policy rate peaking near 2.5% over the next 12 months.



The U.K. economy was already slowing ahead of the April hikes in both the payroll tax and the cap on household energy costs. Both are additional headwinds to households that are already being squeezed by high inflation. Add BOE tightening to the mix and it's clear that growth is at risk in 2022. No wonder the bank has softened its tone lately.

Political risk has fallen as Prime Minister Johnson is likely to hang on despite "Partygate" scandal.[3] However, Chancellor Rishi Sunak's fate is not so clear. His popularity had already taken a hit when his budget provided limited support for struggling households. Sunak was further damaged by reports that his wife did not pay U.K. taxes due to non-domiciled status, as well as them both holding green-card status in the U.S. While it appears that all laws were obeyed, the optics are horrible at a time when the tax burden is rising for most of those living in the U.K.

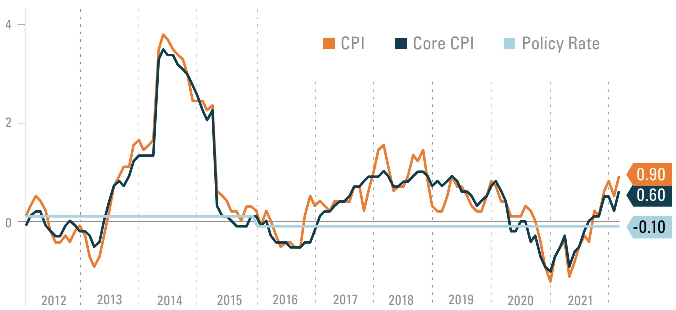
Steady as She Goes: Policy Pacemakers

The Bank of Japan doubled down on Yield Curve Control with aggressive Japanese Government Bond (JGB) purchases as markets tested the upper limit of 0.25% for the 10-year JGB yield. This led to an outsized spike in USD/JPY above 125. The pair corrected lower, but it has since moved steadily higher to trade at new multi-year highs near 130. Long-term charts show that there are no significant chart points until the 2002 high near 135.

[3] https://en.wikipedia.org/wiki/Partygate

There is clearly rising official concern about the exchange rate. Prime Minister Fumio Kishida, Finance Minister Shunichi Suzuki, and BOJ Governor Haruhiko Kuroda have all expressed concern recently about excessive weakness in the yen. However, we believe policymakers are focused more on the pace rather than on any particular levels. FX intervention is unlikely for now as widening monetary policy divergences with the ultra-dovish BOJ support weaken the yen further. In one sense, this is a demonstration of the concept of the so-called "Impossible Trinity" that was popularized by Robert Mundell. This concept stated that in terms of an independent monetary policy, free capital flows, and a fixed exchange rate, a nation cannot have all three. Japan has the first two and so the exchange rate will find its own level.

Japan CPI (y/y)

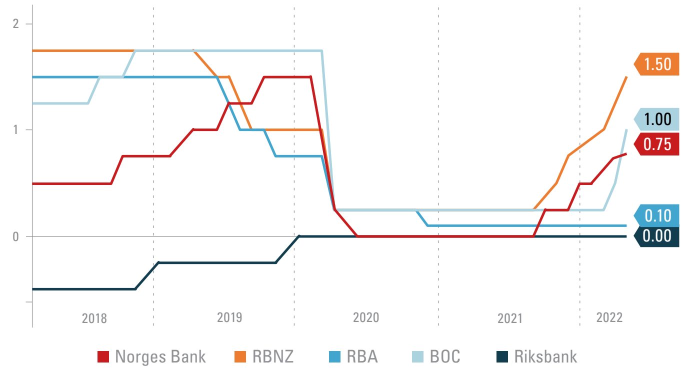


The next BOJ meeting April 27-28 will be very important. Will the bank maintain its ultra-dovish stance in the face of a weak yen? New macro forecasts will be released and FY24 will be added to the forecast horizon. Reports suggest the bank will likely make significant changes to its FY22 inflation and growth forecasts due to high oil and commodity prices. More specifically, the bank will probably raise its FY22 projection for core inflation to 1.5-1.9% vs. 1.1% seen in January. However, sources say that the BOJ will make clear that the updated forecasts are not meant to signal any imminent shift in policy. Indeed, officials stressed that there is no need to tighten policy in the same way as the Fed and other central banks have, as the bank must continue to support the economy by keeping stimulus in place. This suggests the BOJ will maintain its ultra-dovish stance this month.

Dollar Bloc and Scandies

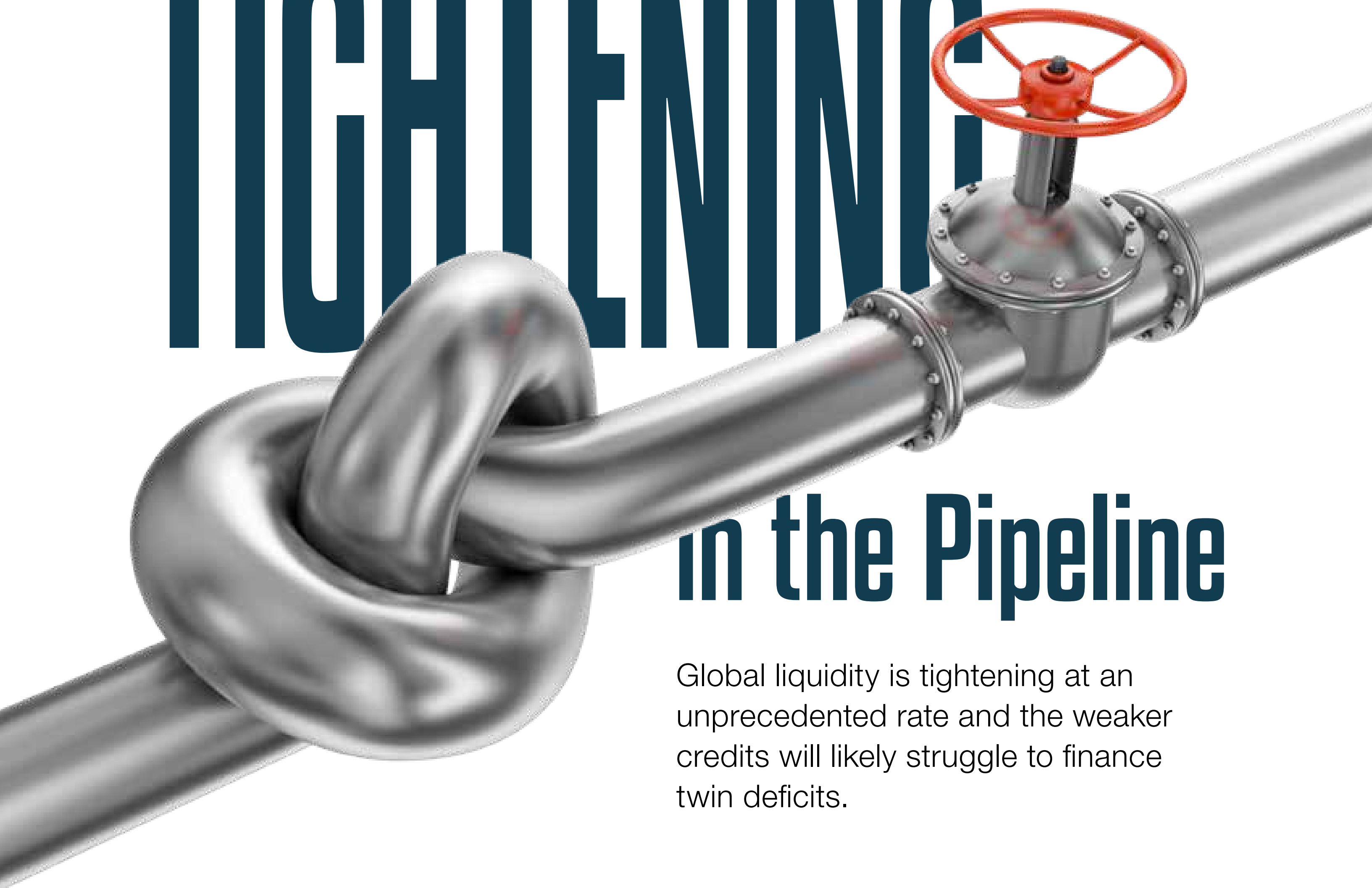
Dollar bloc currencies and "Nokkie" have been boosted by both higher commodity prices and interest rates. These trends are likely to continue in Q2, as the Ukraine crisis shows no signs of ending soon. As a result, commodity prices are likely to remain high. Crude oil, natural gas, and coal are all trading at multi-year highs. Dairy and grain prices are also elevated and so this is likely to keep growth robust for the commodity exporters, which in turn should lead to further monetary tightening and outperformance of the so-called commodity currencies. The top performing major currencies YTD are AUD, CAD, NOK, and NZD and this outperformance should continue. It's worth noting, however, that only AUD and CAD are up YTD against USD and even then, it's not by a lot.

Policy Rates (%)



In terms of central bank tightening, more will be seen in Q2. Norges Bank was the first of the G7 central banks to start tightening back in September; it is expected to hike its policy rate to 2.75% over the next 24 months. Reserve Bank of New Zealand was the next to tighten back in October; it is expected to hike its policy rate to 3.75% over the next 24 months. Bank of Canada was late to the game and started tightening in March. However, it followed up with a 50 bp hike in April and set a very hawkish tone; it is expected to hike its policy rate to 3.5% over the next 24 months. The Reserve Bank of Australia will be the next in this group to hike rates. Liftoff is fully priced in for the June 7 meeting; it is expected to hike its policy rate to 3.25% over the next 24 months. Sweden's Riksbank will be the last of this group to tighten. However, we note that the timeline has been moved up significantly. Liftoff is now fully priced in for the June 30 meeting; it is expected to hike policy rate to 2.5% over the next 24 months.

Lots of TIGHTENING in the Pipeline



Global liquidity is tightening at an unprecedented rate and the weaker credits will likely struggle to finance twin deficits.

We view global monetary tightening as the single biggest headwind for emerging markets (EMs) in the coming quarters. Of the largest major central banks, only the Fed and Bank of England have started tightening cycles and even there, we are closer to the beginning than to the end. With inflation staying much higher than expected for much longer than expected, market expectations for rate hikes globally have been pushed forward and upward. For instance, markets were pricing in a terminal Fed Funds rate of 1.5% at the start of 2022; expectations are now at 3.0% and rising.

Furthermore, it's not just about rate hikes. The Fed is about to announce an aggressive timetable for Quantitative Tightening at the May FOMC meeting that would likely see its balance sheet shrink by over US$1.1 trillion per year. In February, the Reserve Bank of New Zealand was the first to announce that QT would begin in July. The Bank of Canada announced QT would begin in April, while the Bank of England is likely to begin QT in H2 after the policy rate hits 1.0% at its May meeting. European Central Bank's President Christine Lagarde said at the April meeting that it's premature to talk about QT and we suspect this is a 2023 story.

We highlight these developments because Emerging Markets typically benefit from cheap and easy global liquidity. Given such an unprecedented removal of global liquidity that's expected over the next 12-24 months, we can only surmise that EM will struggle to gain traction. Global liquidity is tightening at an unprecedented pace and the weaker credits will likely struggle to finance twin deficits. Weak links in EMs will be tested, while frontier markets like Sri Lanka and Pakistan are already in crisis.

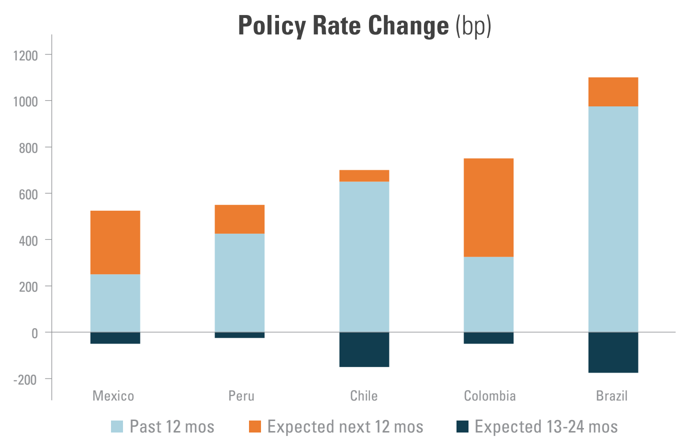
Regional Divergences Likely to Continue

Latin America has been tightening very aggressively. On the other hand, emerging Asia has been the most dovish, and Europe, Middle East, and Africa (EMEA) is somewhere in between but moving closer to Latin America. The regional divergences also break down between commodity exporters and importers. Latin America is made up of major commodity exporters, while Asia and EMEA (with the notable exception of Russia and South Africa) are mostly commodity importers.

Digging deeper into the regional divergences, Central and Eastern Europe (CEE) is the most vulnerable to negative impulses from the Ukraine crisis. On the other hand, emerging Asia will be most vulnerable to the slowdown in the Chinese economy due to trade and investment ties with the mainland. It appears that in this period of elevated commodity prices, Latin American currencies should continue to outperform. In terms of equity markets, MSCI EM is -10.4% YTD. Regionally, MSCI Asia is the worst performer at -12.2% YTD, while EMEA is the best at -6.4%. MSCI Latin America is in between at -8.4% YTD.

Americas

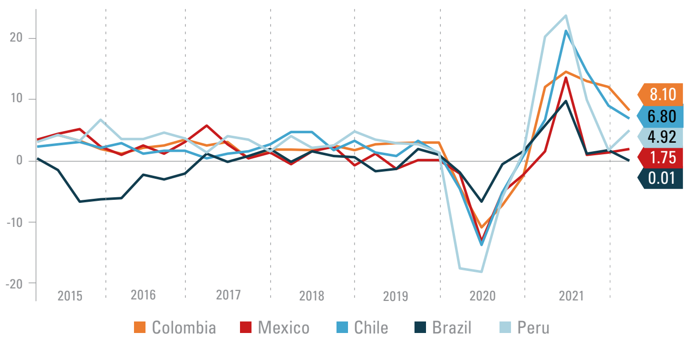
Top EM performers YTD are BRL, COP, PEN, ZAR, CLP, and MXN. The central banks of these nations have been the most aggressive in tightening rates and so it's no surprise that their currencies have outperformed. High commodity prices have also been a major factor behind the stronger currencies. However, there are signs that several Latin American central banks are nearing the end of their tightening cycles, with most policy rates seen peaking over the next 12 months and then falling in the subsequent 12 months. As other regions play catch-up in terms of rate hikes, the relative attractiveness of Latin America may ebb a bit. This is particularly true given aggressive rate hikes are likely to weight on future economic growth. Some signs of slowing are already becoming apparent and that is why some policymakers are tilting less hawkish.



The Brazilian real has been the market darling so far in 2022. This is due mostly to the fact that Brazil has the highest policy rate by far amongst the major EMs. At 11.75% currently, this rate is expected to peak near 13.5% over the next six months before an expected easing cycle begins as we move into 2023. For now, investors are sanguine about the Fall presidential election as former President Lula is widely tipped to defeat current President Bolsonaro. Betting markets such as PredictIt have Lula's odds of winning at nearly 75%. It appears that Bolsonaro is paying the price for a botched COVID response, high inflation, and a slowing economy. That is a toxic combination that will be very hard to overcome.

An aggressive Banco de Mexico tightening cycle has helped the peso outperform so far in 2022. However, along with Brazil, Mexico has seen very sluggish growth over the past several quarters and that is likely to worsen as the central bank continues to hike rates. Swaps markets sees another 275 bp of tightening over the next year that would see the policy rate peak near 9.25%. That is quite a headwind on the economy, though high oil prices and a strong U.S. economy will help offset this. President Andrés Manuel López Obrador, also known as AMLO, is looking increasingly like a lame duck in his final two and a half years in office. For instance, opposition parties in parliament were able to block his proposed constitutional reform that would have restored the electricity sector to state control. AMLO will find it impossible to pass any meaningful reforms after his coalition lost its two-third super-majority in last June's elections.

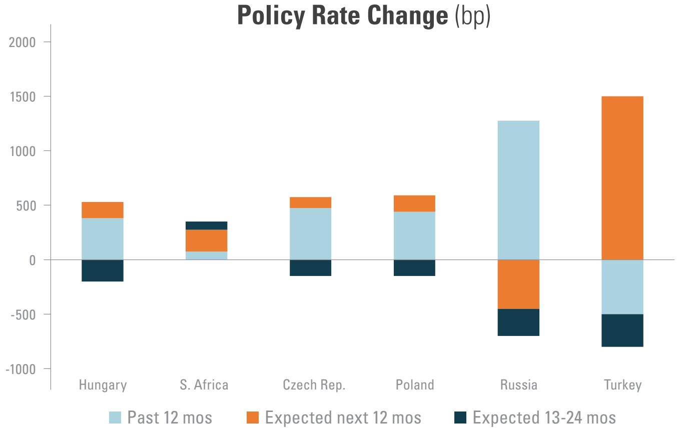
LATAM Monthly GDP Proxies (y/y)



Europe, Middle East, and Africa

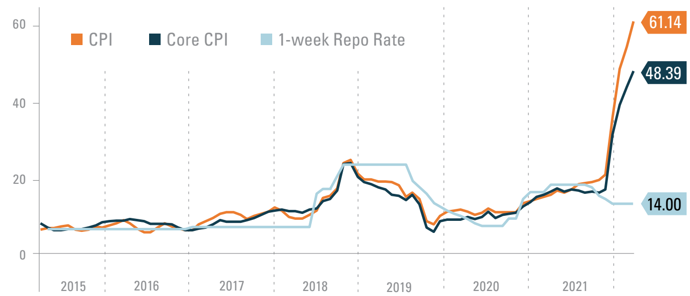
Central and Eastern Europe (CEE) is most vulnerable to negative impulses from the Ukraine crisis due to its proximity. The worst performing EM currencies YTD are ARS, TRY, RUB, HUF, and PLN. The CEE central banks started off their tightening cycles modestly but they have recently started to deliver hawkish surprises to get back ahead of the curve. Turkey (see below) stands out as an exception. More aggressive tightening and negative spillover from the Ukraine crisis will weigh on CEE growth, but for now, the focus for policymakers is firmly on fighting inflation.

Policy Rate Change (bp)



Turkey continues to coast along but a moment of reckoning is approaching. CPI inflation is running above 60% and with PPI rising 115% y/y in March, there are upside risks to inflation in the coming months. Yet the central bank has been on hold at 14% after a short easing cycle of 500 bp last year. The lira has remained remarkably stable in recent weeks, more from the heavy-handed government influence than on any sort of improved fundamentals. Put simply, the current monetary policy framework is unsustainable and markets are looking for an adjustment soon. Both Bloomberg consensus and the swaps market look for a tightening cycle to start in Q2. If nothing else, interest rates must adjust in order to draw in foreign financing of the growing twin deficits in Turkey.

Turkey CPI (y/y)



The Russian economy is cratering, but how badly is anybody's guess. The latest IMF forecasts for Russia see -8.5% in 2022 and -2.3% in 2023 but these are of course subject to revision as the Ukraine crisis plays out. Sanctions continue to bite and are likely to remain in place indefinitely as reports suggest the Western allies are formulating a long-term strategy of isolating Russia. This is a marked change from the previous policy of cooperation and coexistence and this means that Russia will not have access to global capital markets for the foreseeable future. The good news is that there has so far been very little contagion to the strong EM credits. EMBI and EMBI+ spreads have come in sharply from the post-invasion highs but remain in a general uptrend. This is to be expected given rising interest rates and generally tighter liquidity globally. Of note, Russia has been ejected from most major bond and equity indices after sanctions left Russia uninvestable.

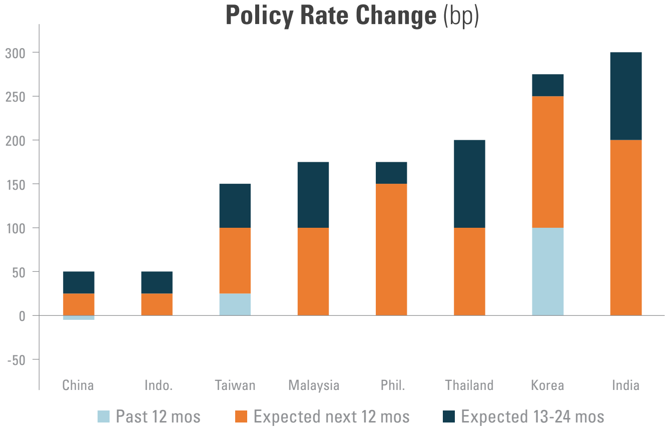
EM Spreads (bp)

Asia

Emerging Asia has been the most dovish within the EMs. Bank of Korea stands out for starting a tightening cycle; with 100 bp of tightening already seen, the swaps market sees the BOK policy rate peaking at 3% over the next 12 months. Another notable exception is the Monetary Authority of Singapore, which has tightened three straight meetings by adjusting the slope and midpoint of its Singapore dollar nominal effective exchange rate (S$NEER) trading band. Lastly, Taiwan began a tightening cycle in March with a 25 bp hike but it is expected to remain modest.

All other central banks have yet to start hiking rates. India, Malaysia, Indonesia, and Philippines liftoffs all expected in Q3, while Thailand liftoff is not expected until Q1 2023. Asia will suffer most from China's slowdown. If the regional slowdown extends or intensifies, many Asian central banks are likely to push out liftoff expectations further.

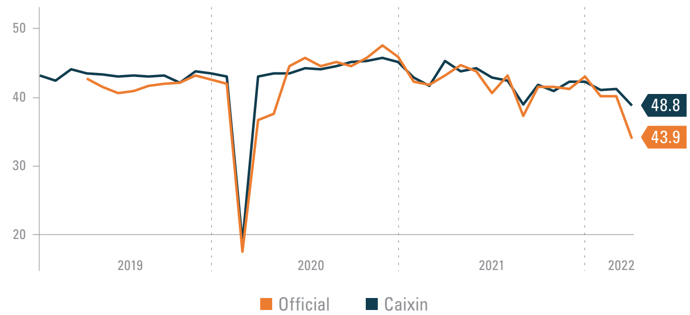
Policy Rate Change (bp)



China Slowdown Will Be Much Deeper than Expected

The Sinovac vaccine efficacy is low, forcing policymakers to increasingly rely on lockdowns to control omicron. More than 80% of the nation is facing medium- to high-risk in terms of COVID numbers and a total of 45 cities have imposed partial or total lockdowns. Official and Caixin PMI readings fell below 50 in March, and they will only get worse in April. Despite the upside surprise to Q1 GDP data, the 2022 growth target of "around 5.5%" is looking increasingly difficult and so more fiscal and monetary stimulus is expected soon.

China Composite PMIs



The People's Bank of China (PBOC) stands out as the only major central bank, both in EMs and Developed Markets (DM), to be in an easing cycle now. Monetary policy divergence is already stark and should continue widening. With growth at risk, more aggressive PBOC easing is likely in Q2. Interest rate differentials with the U.S. have narrowed sharply and this is likely to continue. This central bank divergence should also weaken the yuan further, which will also weigh on foreign fixed income returns. Elsewhere, the uncertainty regulatory environment in China is also likely to keep foreign investors wary.

China-U.S. Spreads (bp)

Currency Forecasts*

Major Markets

In US Dollar Terms	Current	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Euro	1.07	1.05	1.03	1.03	1.04
Yen	127	130	133	135	135
Sterling	1.26	1.24	1.20	1.20	1.22
Canadian $	1.28	1.30	1.35	1.35	1.33
Australian $	0.72	0.71	0.70	0.68	0.70
New Zealand $	0.66	0.65	0.63	0.62	0.64
Swedish Krona	9.48	9.71	10.00	10.10	9.90
Norwegian Krone	9.23	9.52	9.81	9.90	9.62
Swiss	0.96	0.98	1.02	1.04	1.05

In Euro Terms	Current	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Yen	136	137	137	139	140
Sterling	0.84	0.85	0.86	0.86	0.85
Swiss Franc	1.02	1.03	1.05	1.07	1.09
Swedish Krona	10.10	10.20	10.30	10.40	10.30
Norwegian Krone	9.83	10.00	10.10	10.20	10.00

Emerging Markets

In US Dollar Terms	Current	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Chinese Yuan	6.56	6.65	6.75	6.85	7.00
Hong Kong $	7.85	7.85	7.85	7.85	7.85
Indian Rupee	76.58	78.00	80.00	82.00	80.00
Korean Won	1251	1275	1300	1300	1275
Indonesian Rupiah	14411	15000	15500	15250	15000
Singapore Dollar	1.38	1.39	1.40	1.42	1.41
New Taiwan $	29.30	29.50	30.00	30.50	30.00
Thai Baht	34.28	35.00	36.00	36.50	36.00
Brazilian Real	4.98	5.05	5.15	5.15	5.10
Mexican Peso	20.35	21.00	22.00	21.50	21.00
Czech Koruna	22.96	23.33	24.03	23.79	23.32
Hungarian Forint	353	362	379	388	375
Polish Zloty	4.39	4.48	4.61	4.71	4.62
Russian Ruble	74.77	75.00	80.00	85.00	80.00
S. African Rand	15.81	16.25	16.75	16.50	16.25
Turkish Lira	14.80	15.50	16.25	16.00	15.75

In Euro Terms	Current	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Czech Koruna	24.48	24.50	24.75	24.50	24.25
Hungarian Forint	376	380	390	400	390
Polish Zloty	4.68	4.70	4.75	4.85	4.80

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

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