

Deutsche Bank
Research



FX review and outlook

George Saravelos

Global Head of FX Research
Deutsche Bank, May 2022

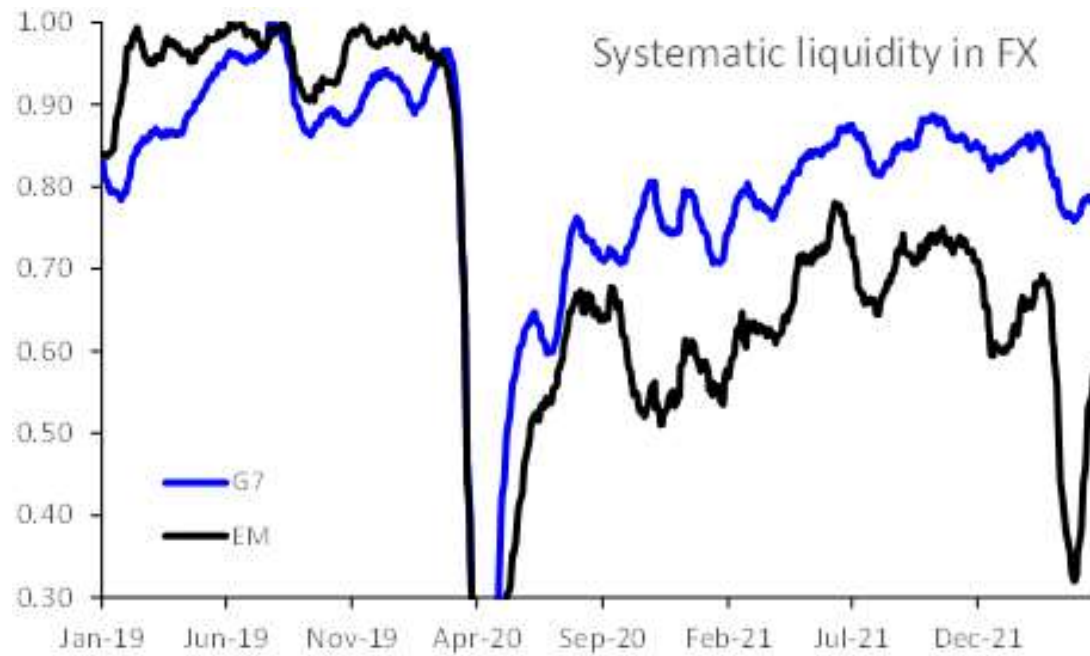
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Market liquidity after the Russian invasion



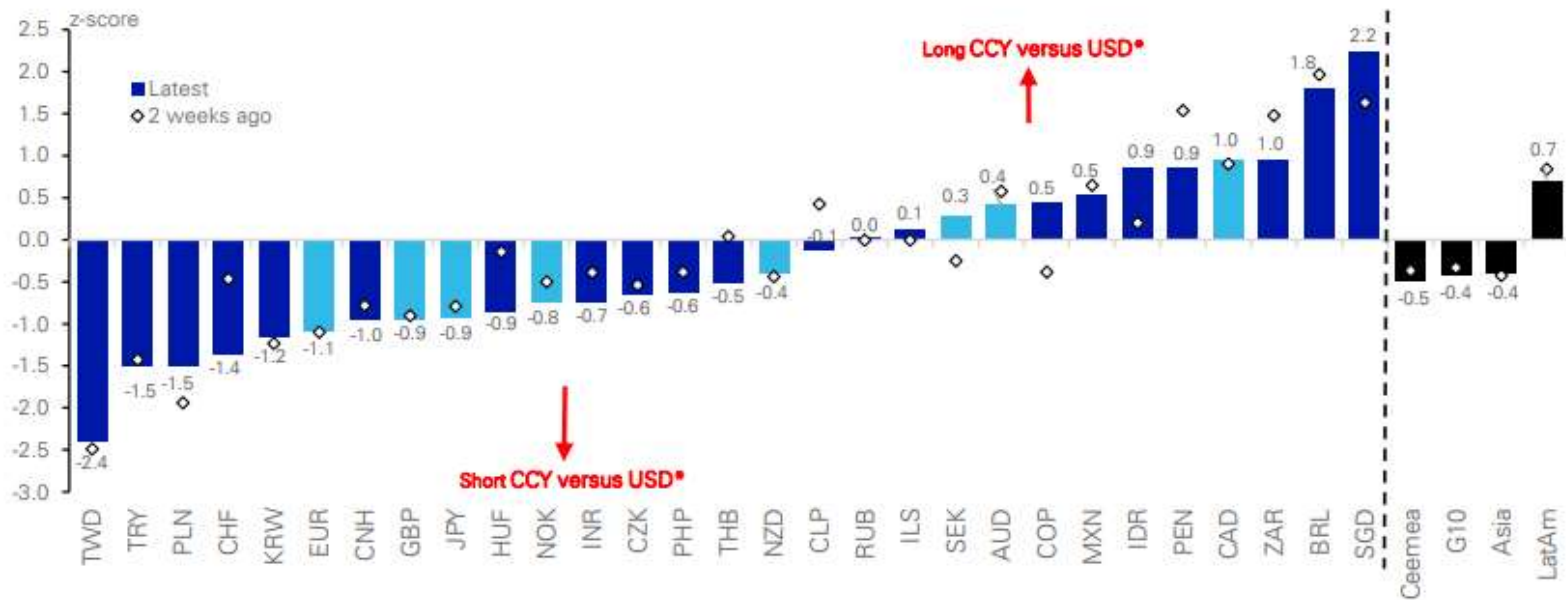
Liquidity has deteriorated, predominantly in Eastern Europe FX



Market positioning after the Russian invasion



The market is generally short European and Asian currencies, versus long USD and Latin America



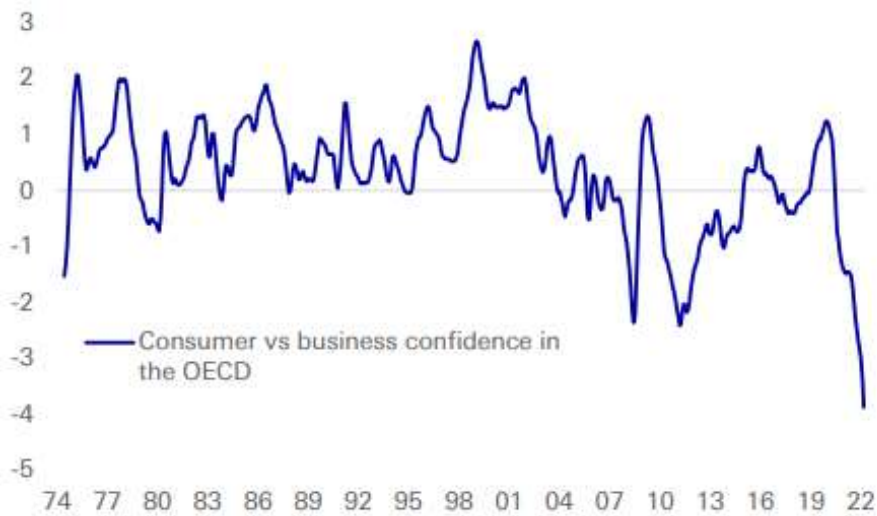
Source : Deutsche Bank, Bloomberg Finance LP, DTCC, EBS, Reuters, IMM, CORAX

Note: 1) * Long (or short) versus EUR for CZK, HUF, PLN, CHF, NOK and SEK. 2) The black bars on the right-hand side are average positioning levels for G10, Asia, CEEMEA and LatAm. 3) The y-axis shows readings of positioning index in a z-score format, which is an average of rolling two years z-scores for individual sub-indicators. Thus, the long or short of each currency is relative to its two years' average instead of absolute level.

Macroeconomic picture after the Russian invasion



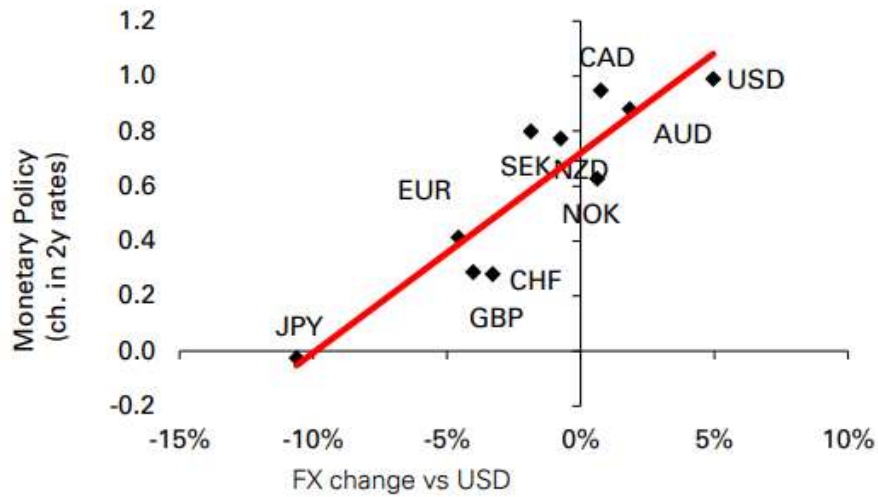
Record high divergence between consumer and business confidence



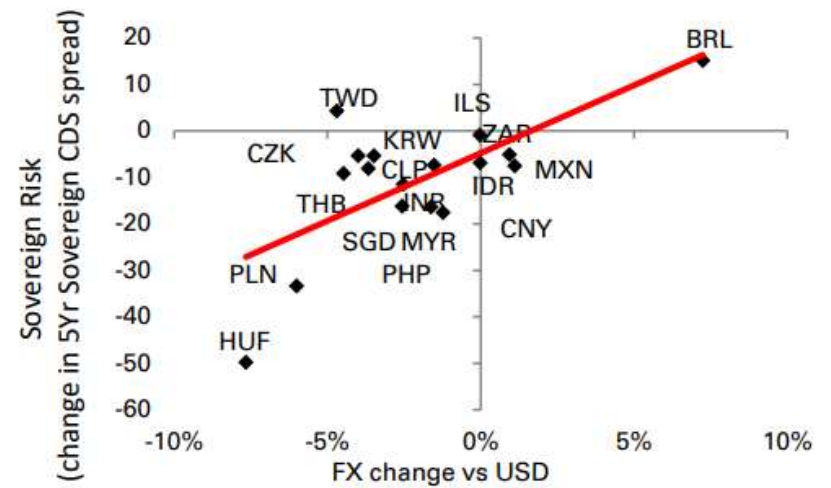
FX performance since the Russian invasion



Monetary policy dominant driver for G10



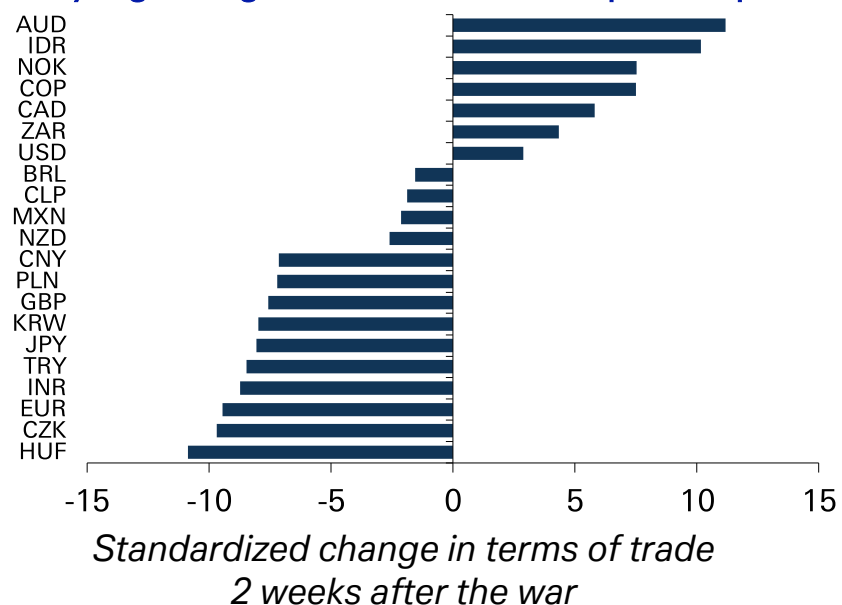
Sovereign risk dominant driver for EM



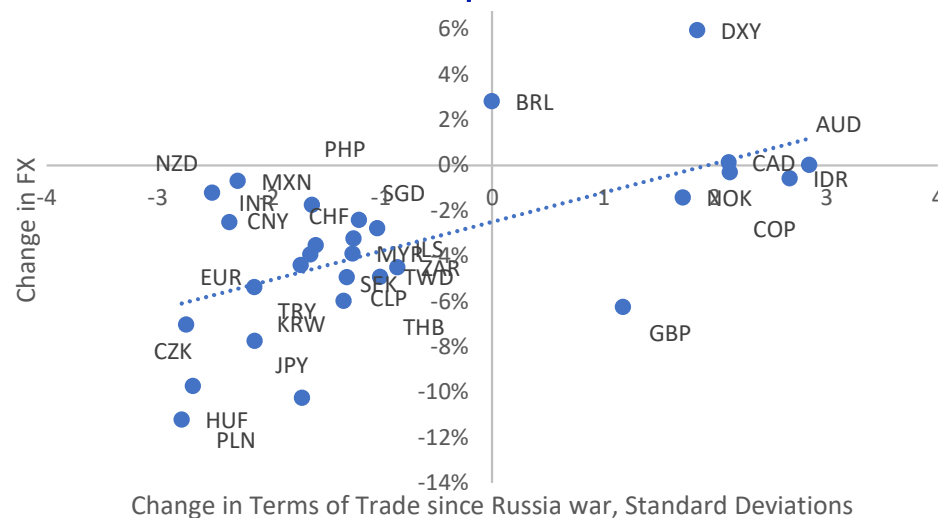
The commodity impact on FX was short-lived



Very big change in terms of trade at peak impact



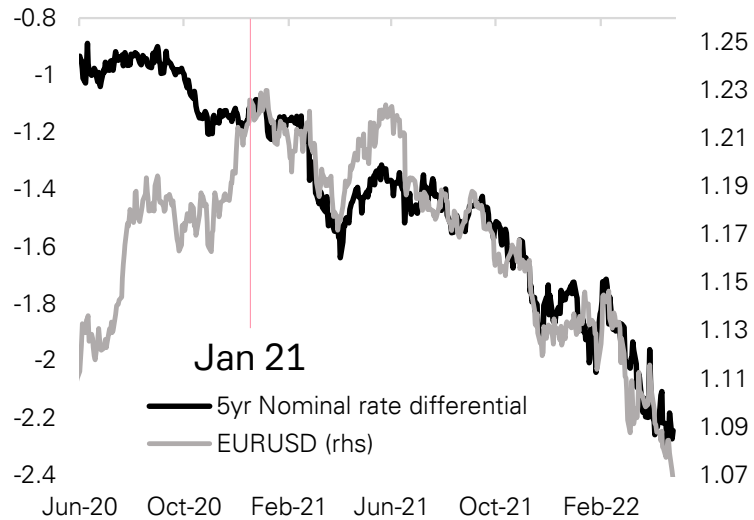
Correlation between FX performance and commodities quite low



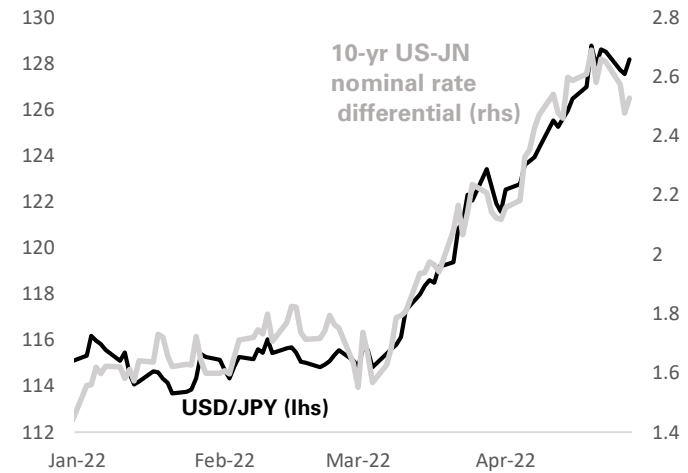
Rate differentials have been dominating G10 FX market



EURUSD correlation with rates high since 2021



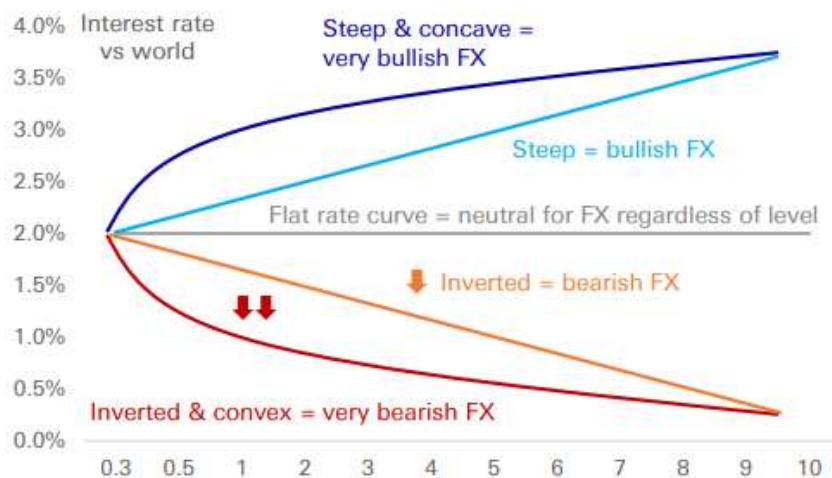
USD/JPY correlation sharply picked up in 2022



The shape of the yield curve is very important for G10 FX



Shape of curve and impact on FX



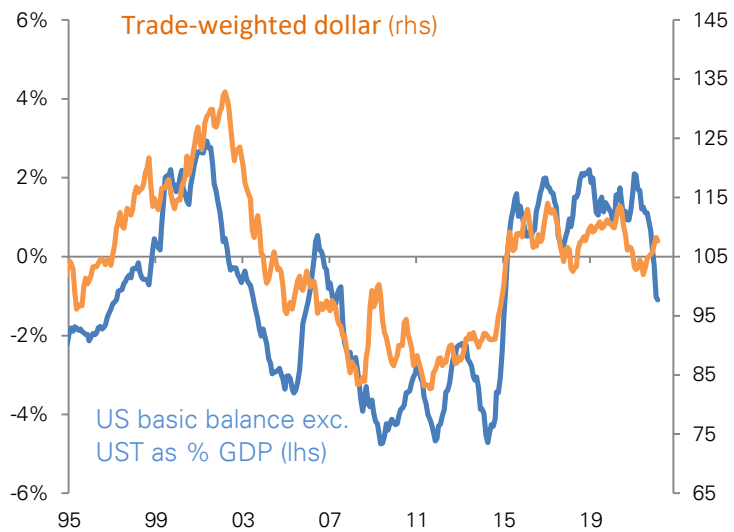
Current US curve shape supportive of USD



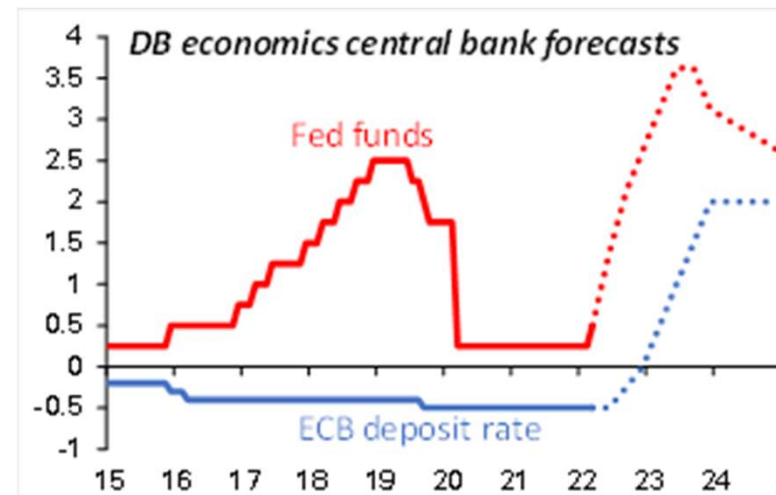
USD outlook: peaking and significant weakness coming



The underlying US flow picture is rapidly deteriorating



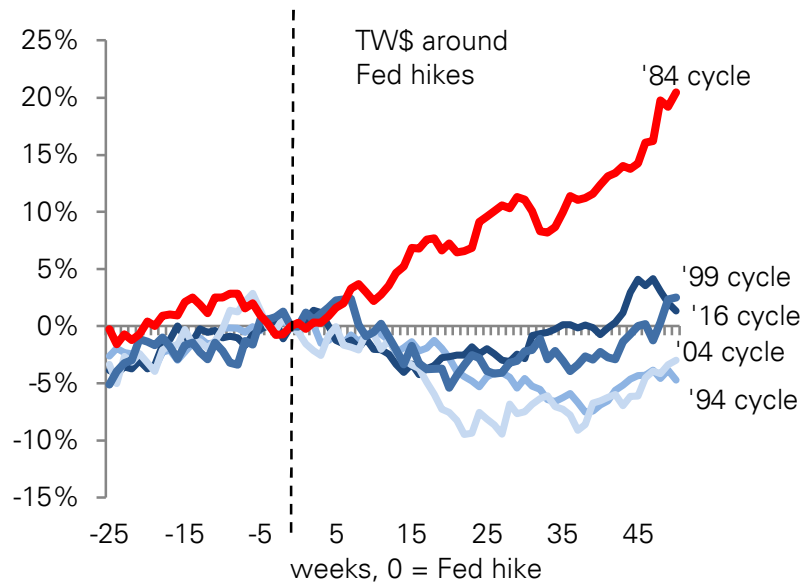
We see Fed pricing approaching peak and a US recession



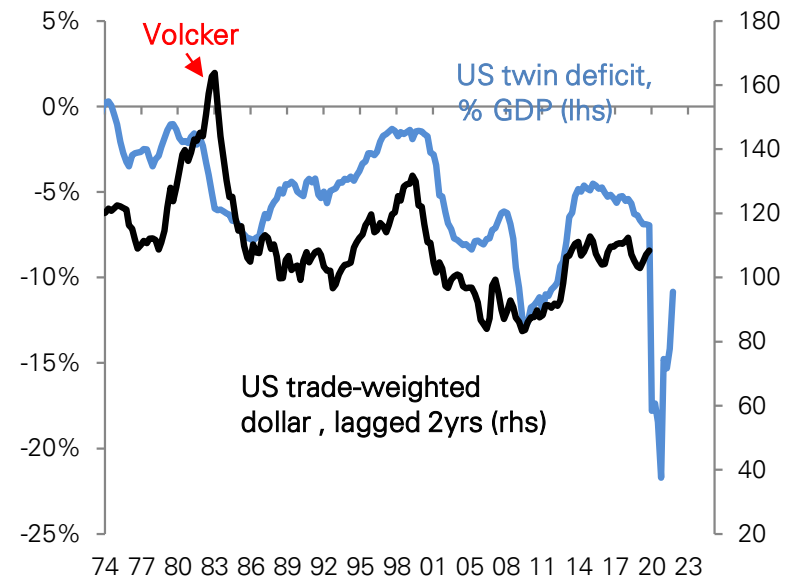
The 1984 Volcker experience



Dollar rallied as the Fed was hiking



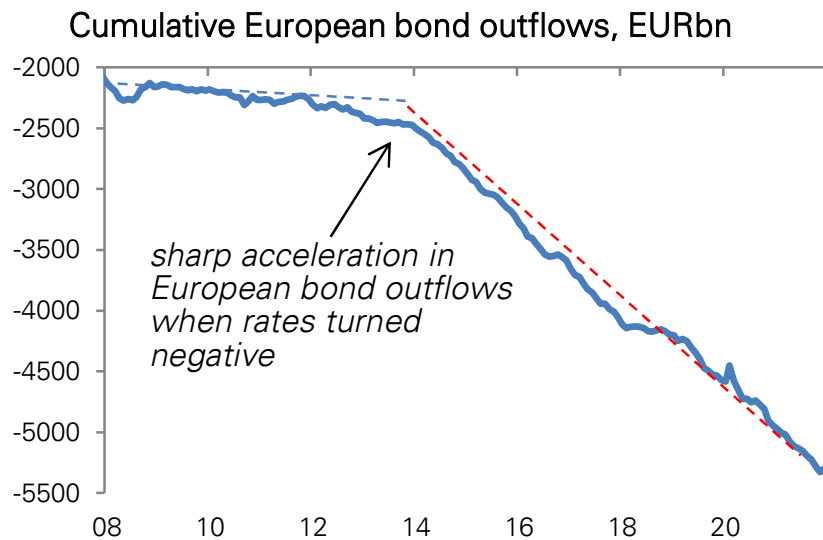
But sharp reversal



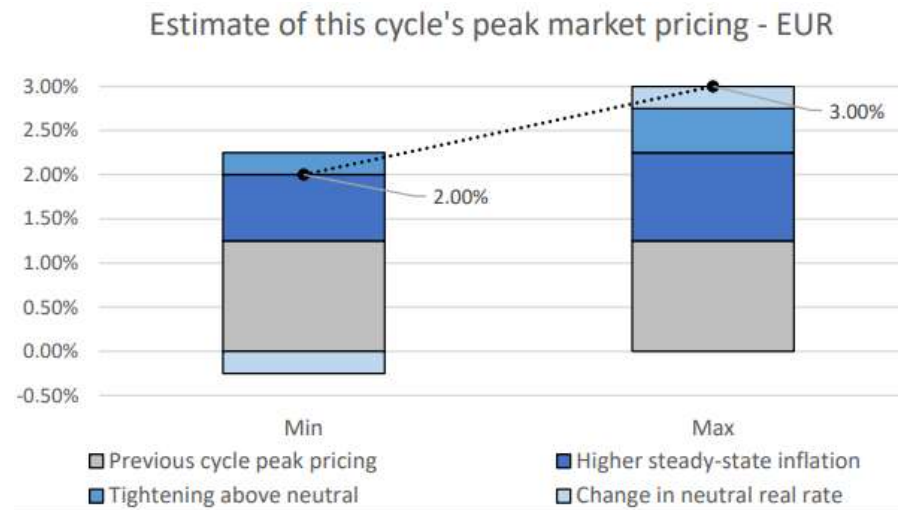
EUR/USD considerations



Strong non-linearities around negative rates



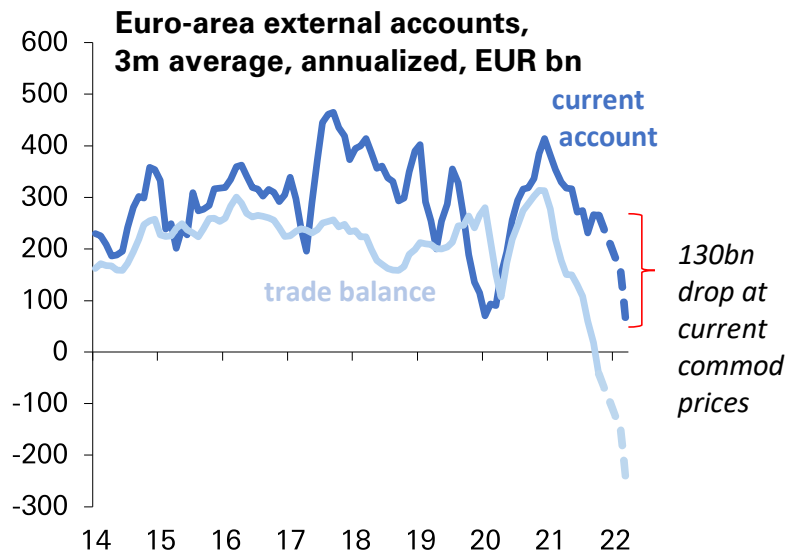
We estimate ECB terminal in 2%-3% range, above market pricing



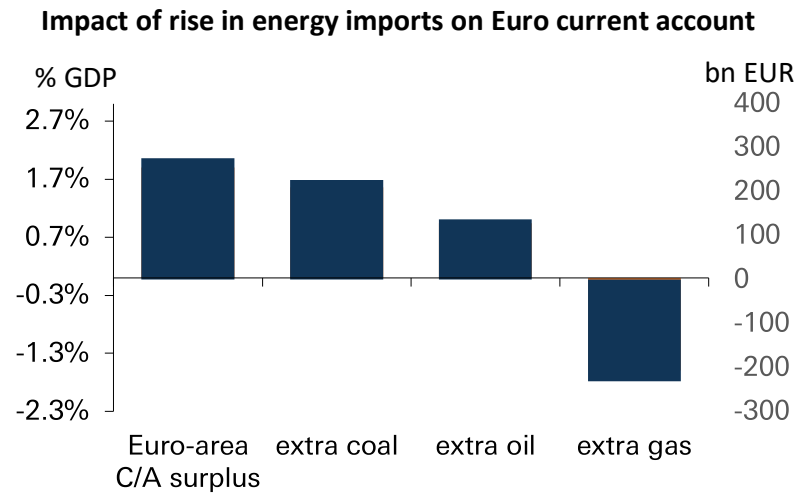
EUR/USD considerations



An energy embargo remains the biggest concern



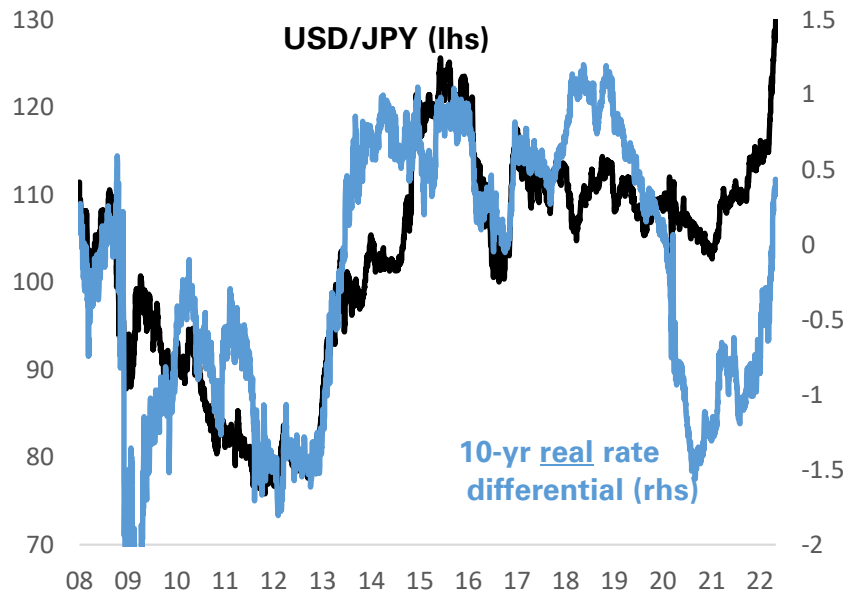
At peak commodity stress, we estimated a 400bn higher energy bill for Europe



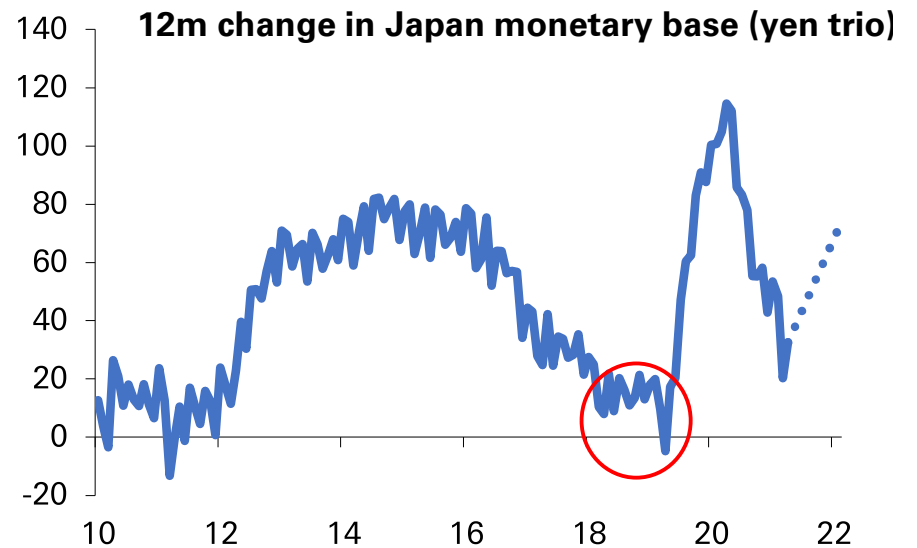
USD/JPY considerations



USD/JPY is “too high” versus rates



However the BoJ is now expanding its balance sheet



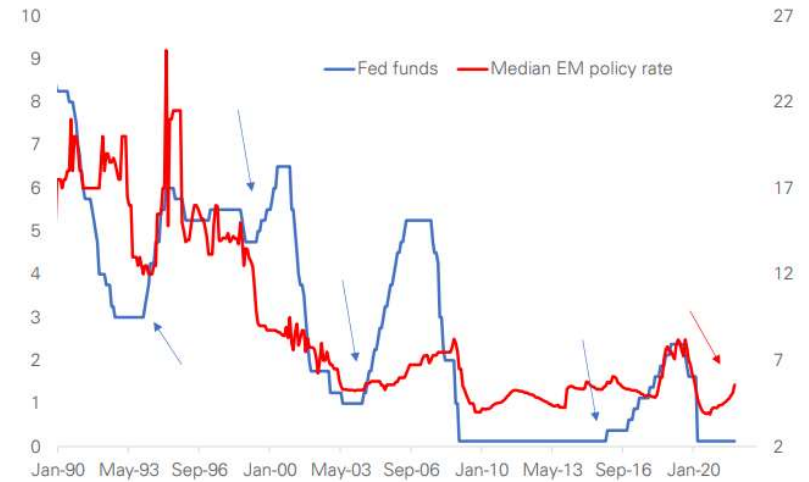
Emerging Markets FX – growth the major driver, at risk



The growth differential with DM explains medium-term performance



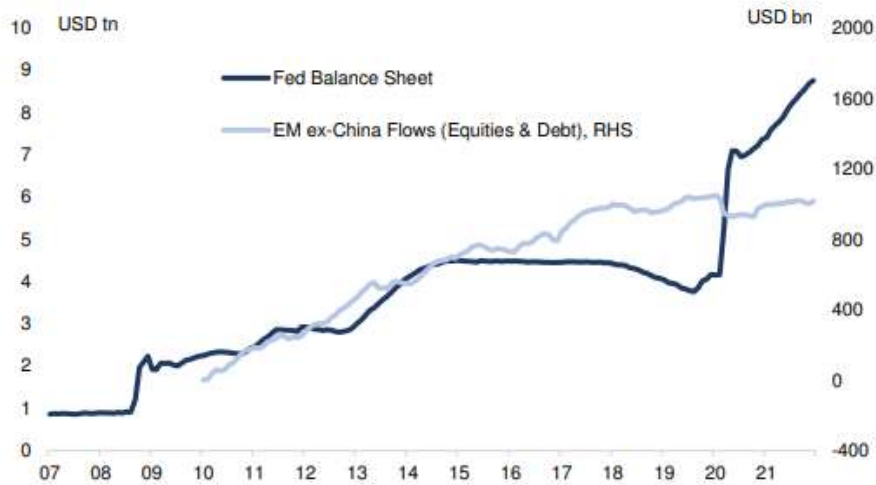
Pre-emptive EM hikes have provided Fed buffer



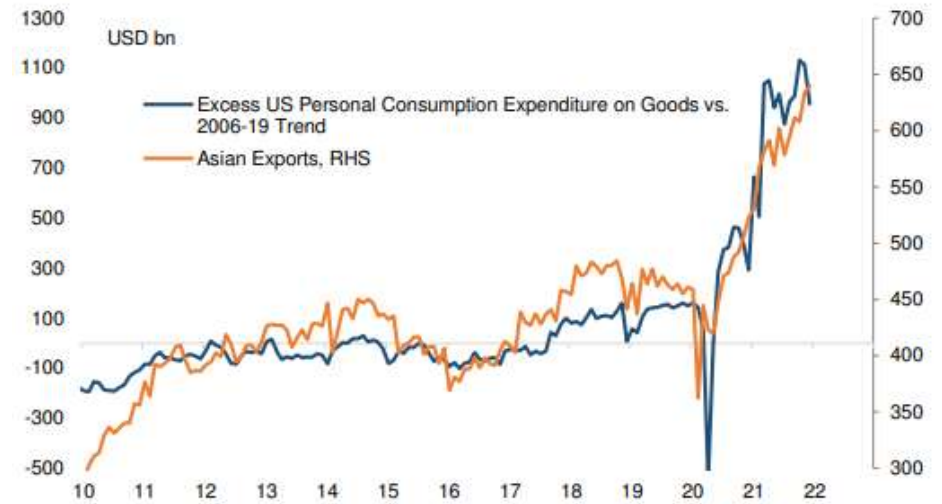
Impact of Fed tightening on EM FX likely largest in Asia



Outside of China, no capital flows to unwind



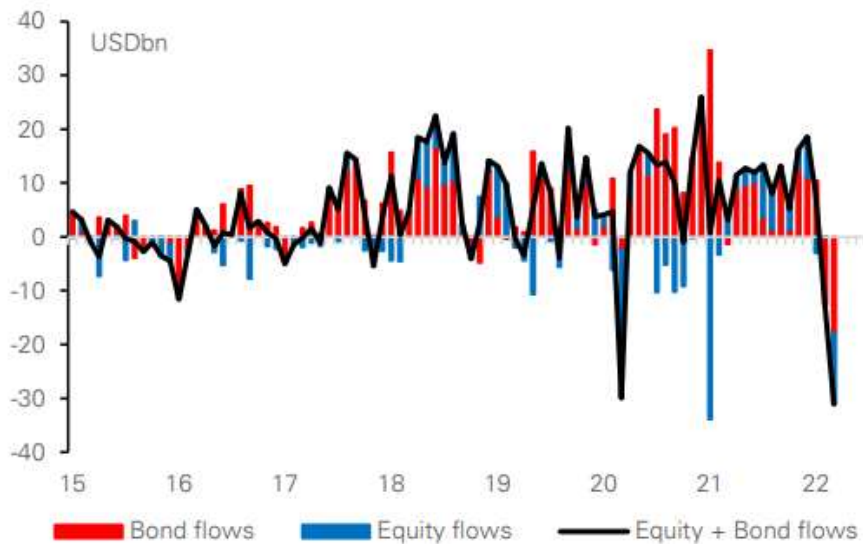
The main transmission of policy was via trade channel



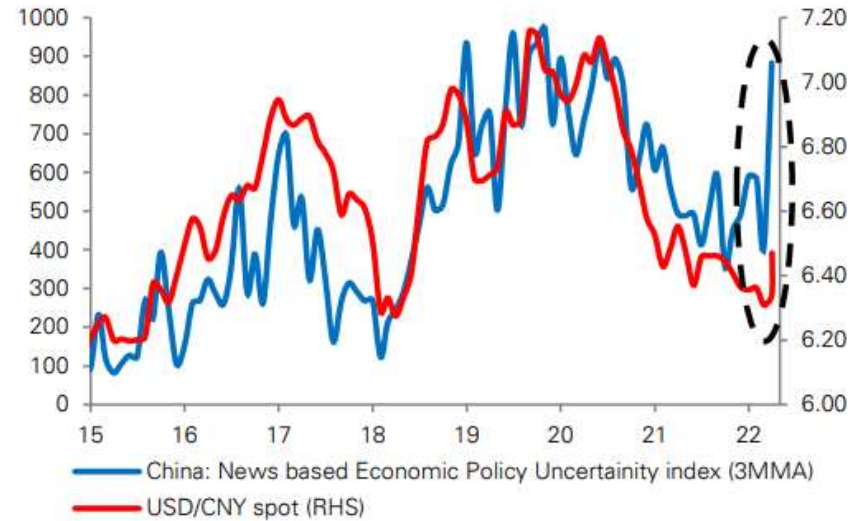
In China, there are capital flow and domestic growth risks



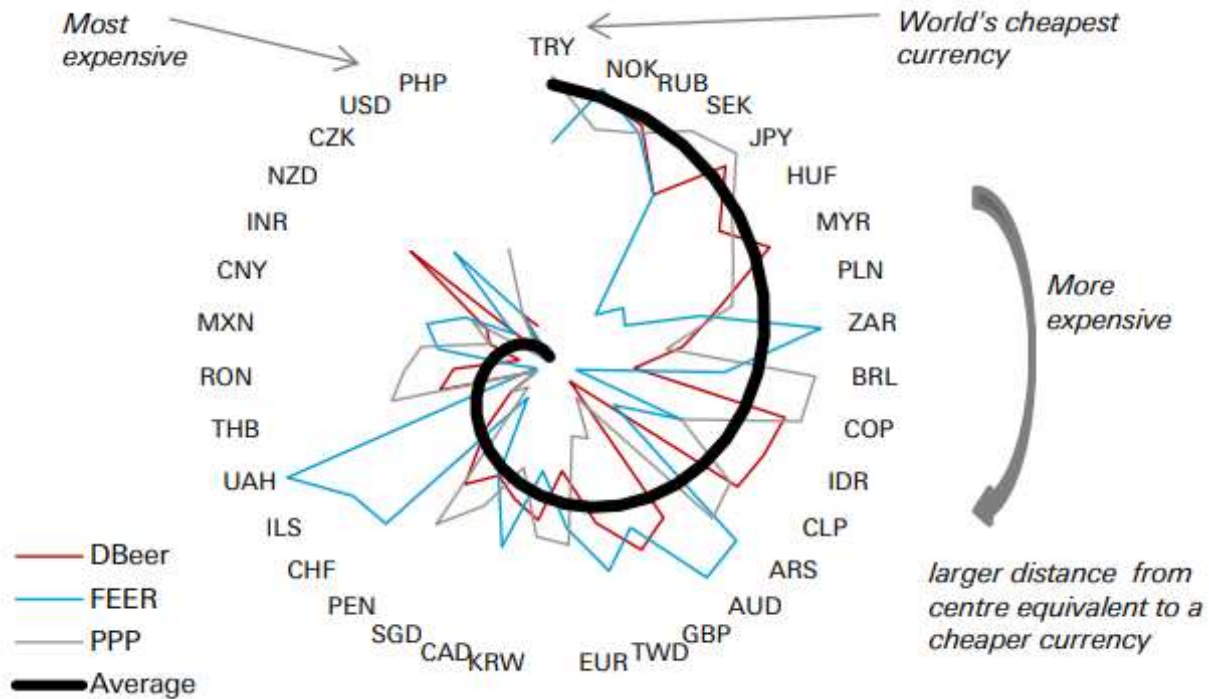
Very large China capital outflows in Q1



Growth (COVID) uncertainty not helping



Latest currency valuations



Summary



1. Monetary policy has been the dominant driver of G10 FX both before, and after the Russia invasion. We expect this to continue.
2. Front-loaded Fed hikes are providing material support to the dollar. We see Fed pricing peaking and a greater repricing in the rest of G10 so the dollar should peak later in the year.
3. A gas embargo is the biggest downside risk to EUR/USD.
4. Growth dominates as a driver of EM FX. Downside growth risks – especially out of China – will continue to be a major headwind.
5. Front-loaded monetary tightening and the absence of significant capital inflows (excluding China) is however providing insulation to many EMs.

Appendix 1

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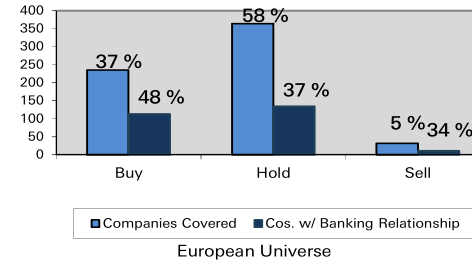
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