FX review and outlook

George Saravelos
Global Head of FX Research
Deutsche Bank, May 2022

All charts sourced from Deutsche Bank research / Bloomberg
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, finanace LP, DTCC, EBS, Reuters, IMM, CORAX

Note: 1)* Long (or short) vs 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 levels in a z-score format, which is an average of rolling two year 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

Standardized change in terms of trade

Change in Terms of Trade since Russia war, Standard Deviations

-14%  -12%  -10%  -8%  -6%  -4%  -2%  0%  2%  4%  6%

-4 -3 -2 -1 0 1 2 3 4

Change in FX

BRL  CAD  AUD  DXY

-4% -3% -2% -1% 0% 1% 2% 3% 4%
Rate differentials have been dominating G10 FX market

**EURUSD correlation with rates high since 2021**

Jan 21

-0.8
-1
-1.2
-1.4
-1.6
-1.8
-2
-2.2
-2.4

5yr Nominal rate differential

EURUSD (rhs)

**USD/JPY correlation sharply picked up in 2022**

10-yr US-JN nominal rate differential (rhs)

Jan 21
The shape of the yield curve is very important for G10 FX

**Shape of curve and impact on FX**

- Steep & concave = very bullish FX
- Steep = bullish FX
- Flat rate curve = neutral for FX regardless of level
- Inverted & convex = very bearish 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

TW$ around Fed hikes

'84 cycle

'99 cycle

'16 cycle

'04 cycle

'94 cycle

US trade-weighted dollar, lagged 2yrs (rhs)

US twin deficit, % GDP (lhs)

Volcker

74 77 80 83 86 89 92 95 98 01 05 08 11 14 17 20 23

-25% -20% -15% -10% -5% 0% 5% 10% 15% 20% 25%

-15 -10 -5 5 10 15 20 25 30 35 40

0 50 100 150 200 250 300 350 400
EUR/USD considerations

Strong non-linearities around negative rates

Cumulative European bond outflows, EURbn

sharp acceleration in European bond outflows when rates turned negative

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

Estimate of this cycle's peak market pricing - EUR

Min
- Previous cycle peak pricing
- Tightening above neutral

Max
- Higher steady-state inflation
- Change in neutral real rate
EUR/USD considerations

An energy embargo remains the biggest concern

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

Impact of rise in energy imports on Euro current account

Euro-area external accounts, 3m average, annualized, EUR bn

130bn drop at current commod prices
USD/JPY considerations

USD/JPY is “too high” versus rates

-2 -1.5 -1 -0.5 0 0.5 1 1.5

70 80 90 100 110 120 130

08 09 10 11 12 13 14 15 16 17 18 19 20 21 22

10-yr real rate differential (rhs)

However the BoJ is now expanding its balance sheet

12m change in Japan monetary base (yen trio)

10 12 14 16 18 20 22

70 80 90 100 110 120 130 140 -20 -10 0 20 40 60 80 100 120 140
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
Important Disclosures
*Other information available upon request

Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors. Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at https://research.db.com/Research/Disclosures/CompanySearch. Aside from within this report, important conflict disclosures can also be found at https://research.db.com/Research/Topics/Equities?topicId=RB0002 under the “Disclosures Lookup” and “Legal” tabs. Investors are strongly encouraged to review this information before investing.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. George Saravelos
Buy: Based on a current 12-month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock.

Hold: We take a neutral view on the stock 12 months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:
1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:
   - Buy: Expected total return (including dividends) of 10% or more over a 12-month period
   - Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
   - Sell: Expected total return (including dividends) of -10% or worse over a 12-month period