

ECB Foreign Exchange Contact Group

Review of recent markets developments and outlook

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Global Markets Division

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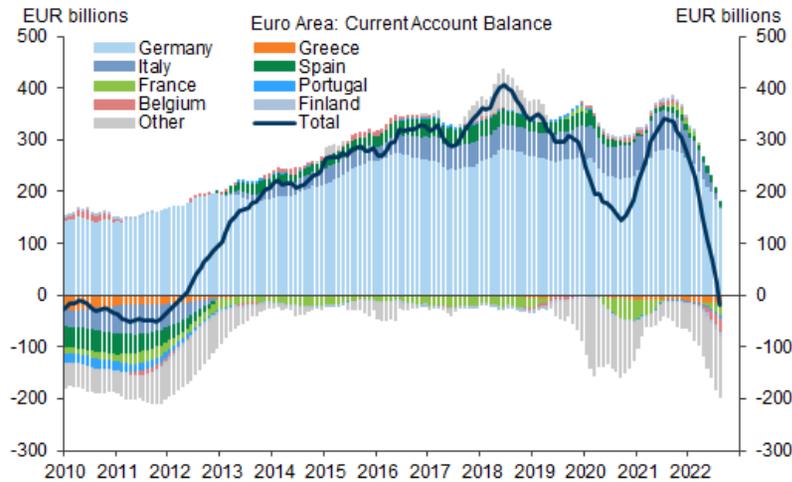
- 1. FX performance, backdrop and outlook**
- 2. European economic summary**
- 3. China developments and FX market implications**
- 4. EMFX performance and drivers**
- 5. FX volatility market developments**
- 6. Latest FX spot market structure developments**
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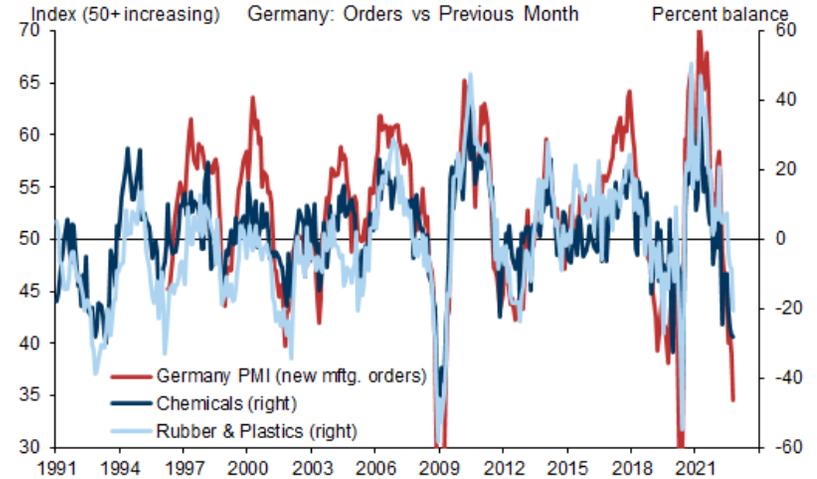
FX performance, backdrop and outlook

EUR/USD drivers: Terms of trade, supply shocks, policy

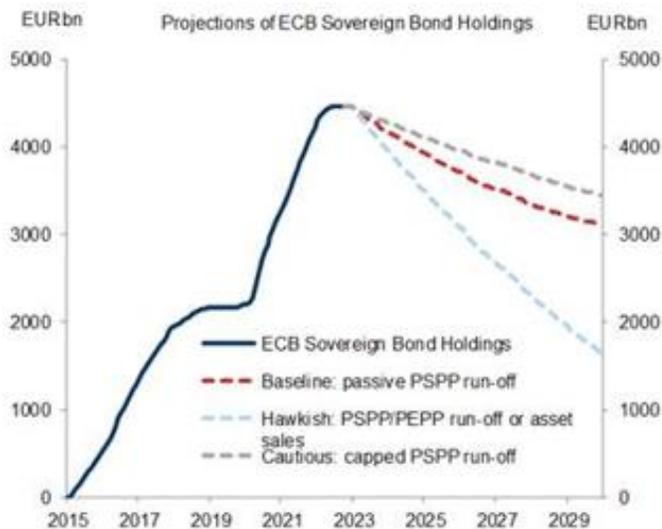
The Euro area current account has weakened substantially



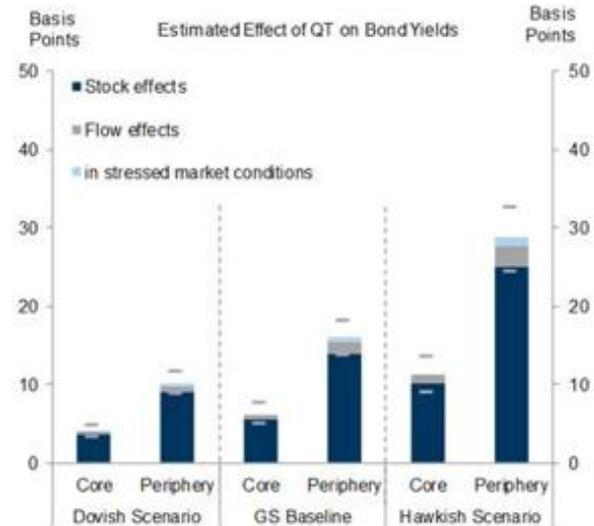
Energy-intensive manufacturing orders are falling rapidly



Expected Gradual ECB Balance Sheet Unwind



ECB QT next year should push 10y Bund yield about 10bp higher

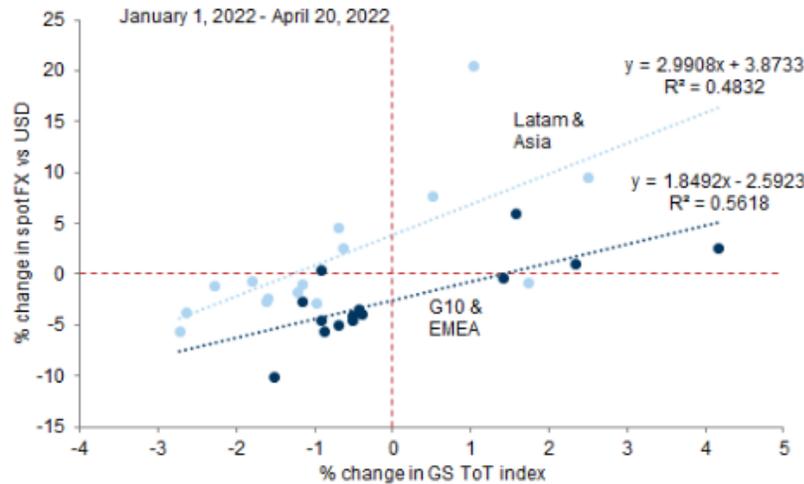


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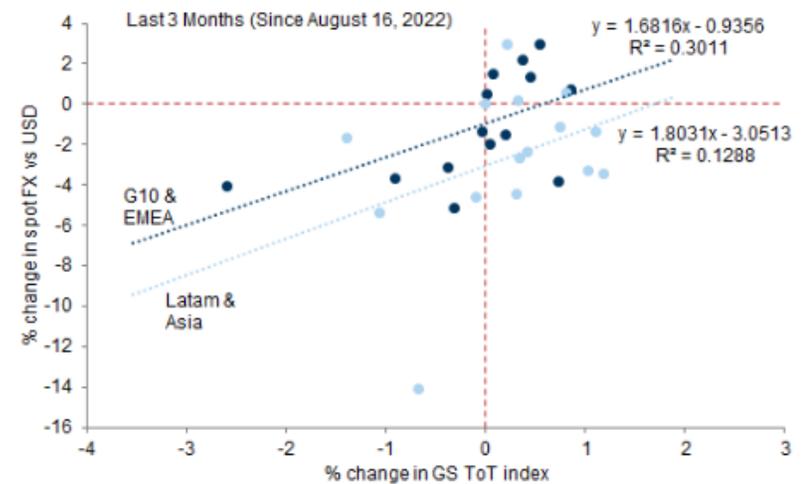
FX performance, backdrop and outlook

Global FX drivers: Terms of trade, interventions, interest rate uncertainty

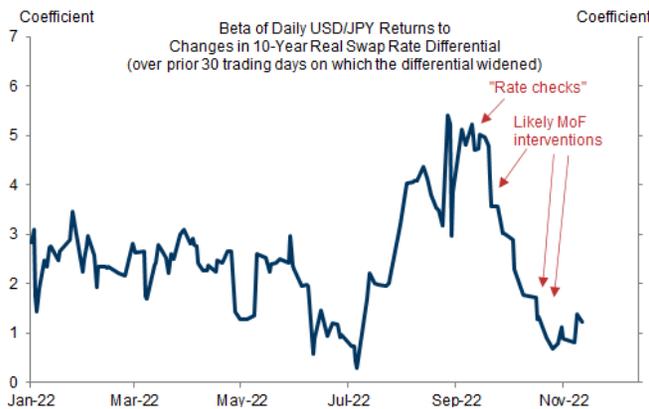
Terms of trade shocks can explain roughly 50% of major FX moves in early 2022...



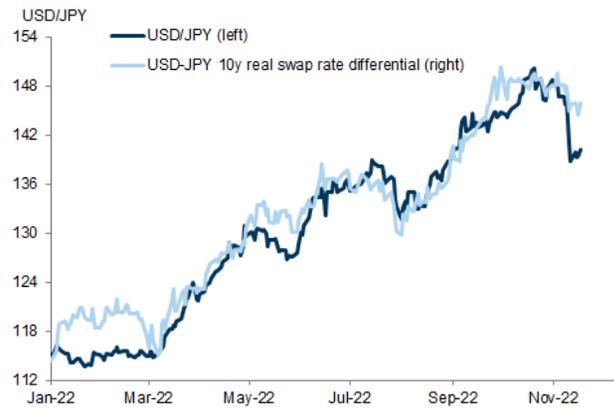
... but less so in recent months, perhaps due to broad USD strength



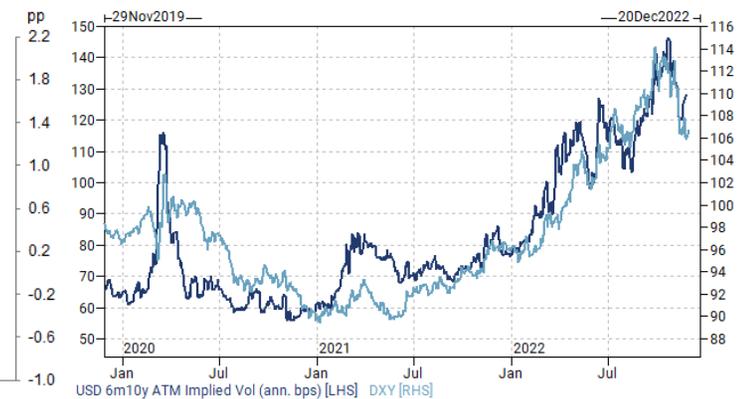
Despite FX interventions that have dampened Yen depreciation pressure from rising US yields...



...USD/JPY has still broadly moved with rate differentials this year, excluding the latest reversal



DXY correlating closely with US rates volatility



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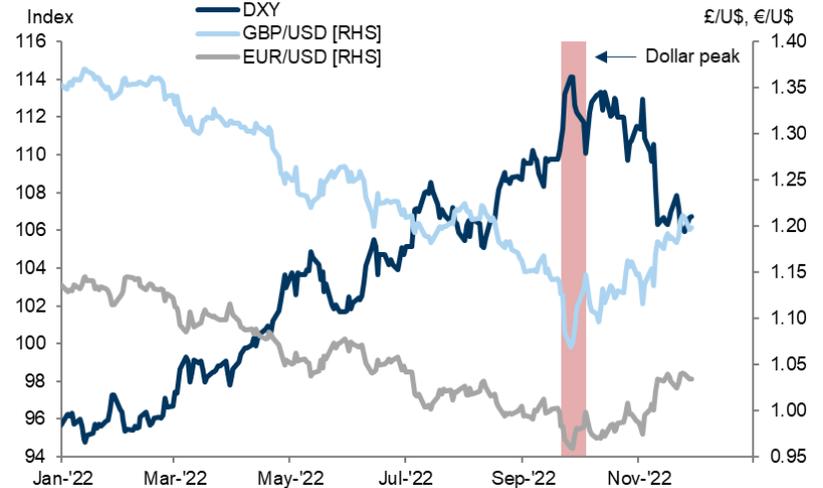
FX performance, backdrop and outlook

The Dollar peak: GBP pressures, FCI turning, positioning unwind

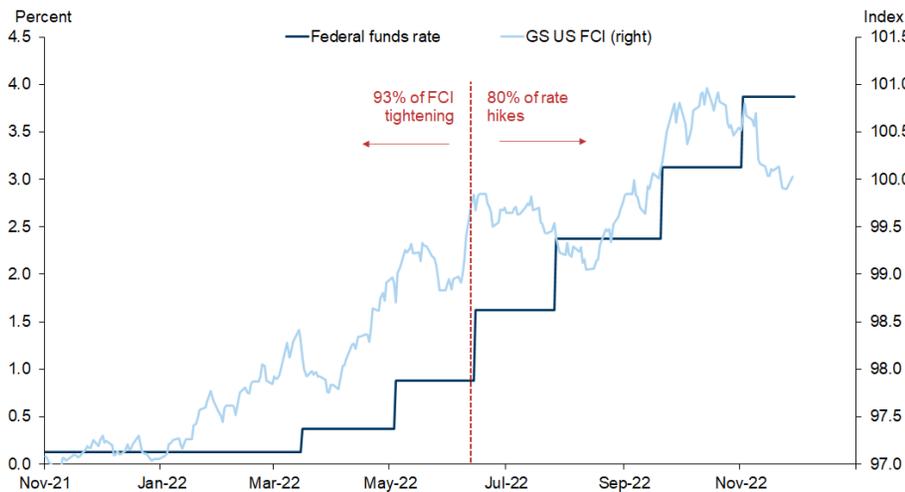
GBP peak pressure caused by fiscal panic...



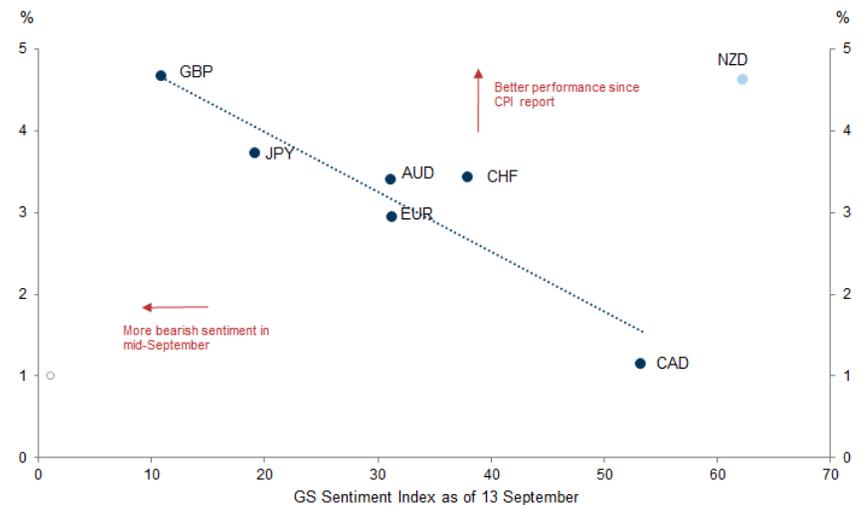
... and coincided with a peak in the broader Dollar



Most of US financial conditions tightening had happened by the June FOMC meeting



Recent FX performance driven by positioning

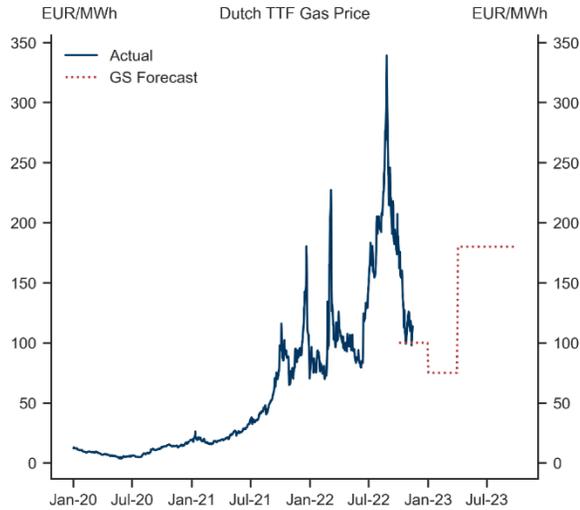


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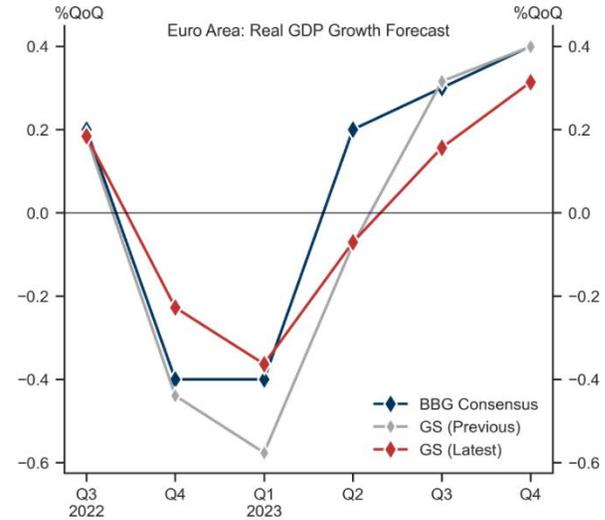
European economic summary

Core Eurozone: milder recession, higher terminal rate

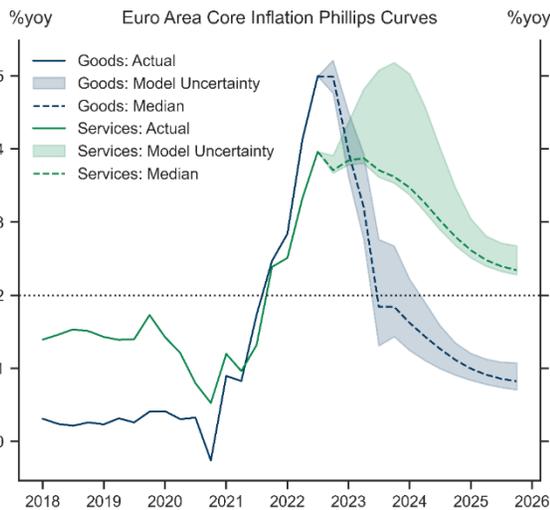
Drags on the Recovery



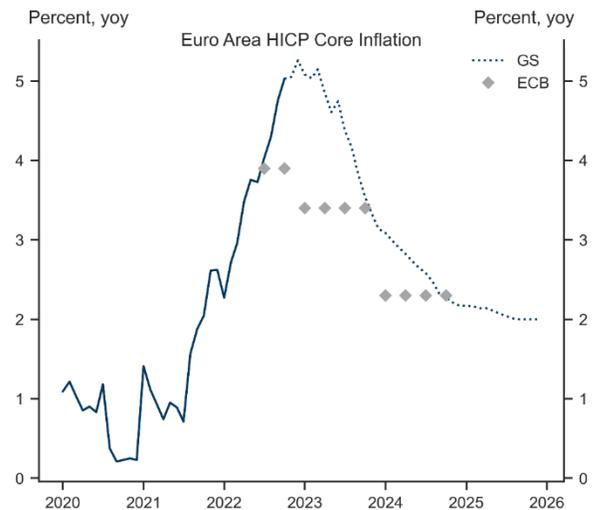
Shallower Recession, Muted Recovery



Persistent Core Pressures



Inflation Peak in Sight

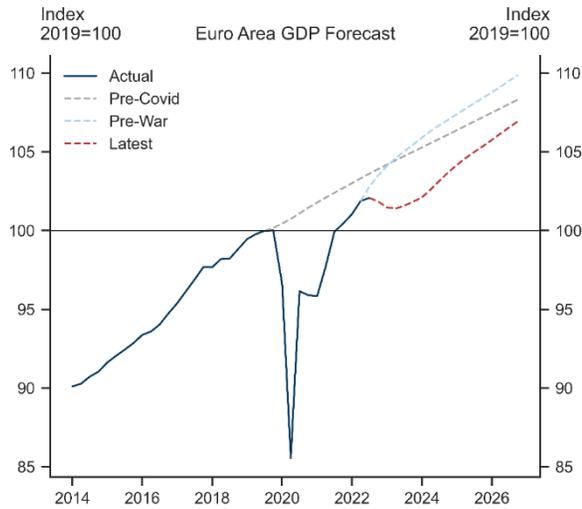


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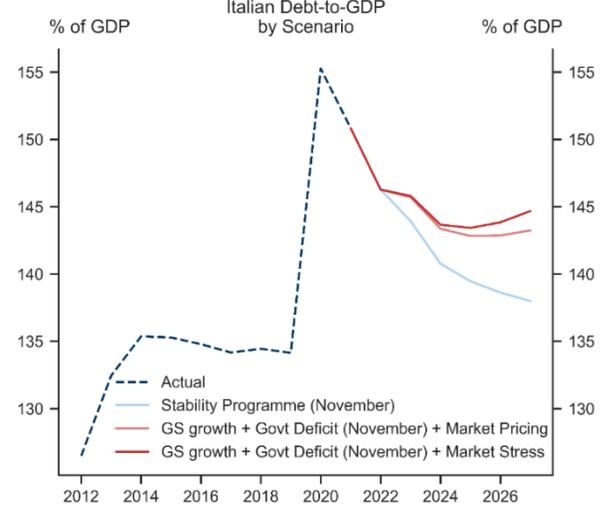
European economic summary

Ongoing risks: cost of war, Italian fiscal risk, UK stagflation

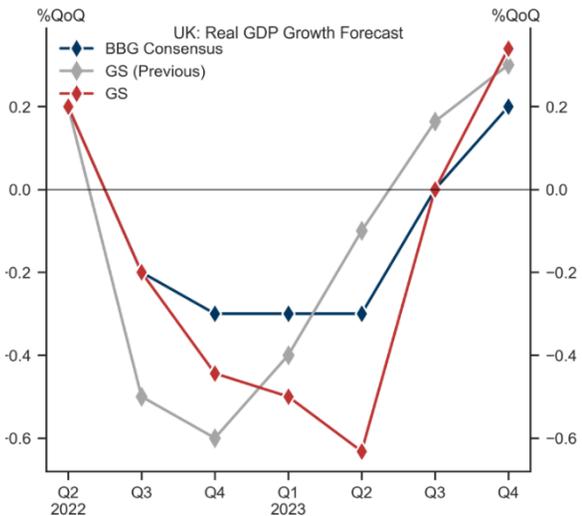
The Permanent Cost of the Energy Crisis



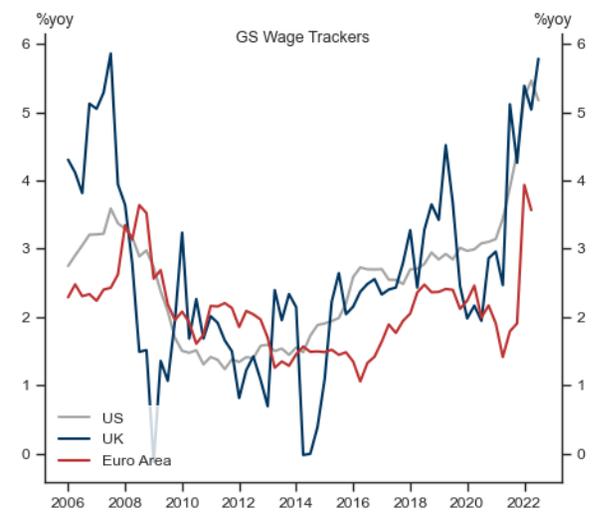
The Risk of Sovereign Stress Remains



A Significant UK Recession



A Hotter UK Labour Market



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China developments and FX markets

Covid and property in focus. Rate differentials and portfolio outflows drove weaker RMB and remain in play

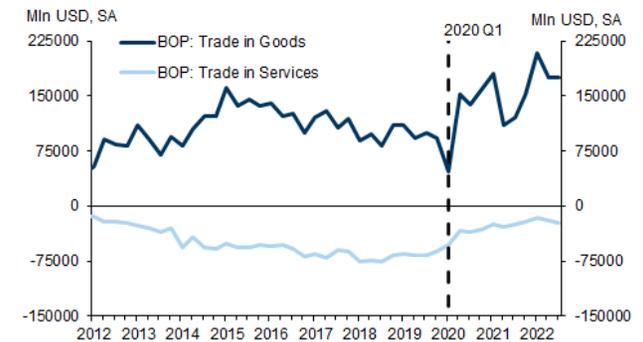
Property sales and Fixed Asset Investment declined sharply



Covid restriction impact has surged



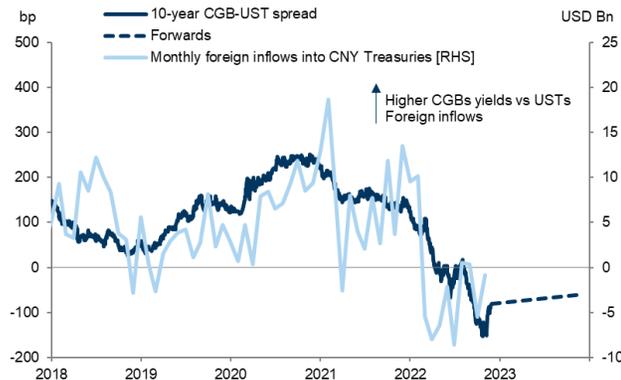
Pandemic-induced boost to external balances should reverse as the economy reopens



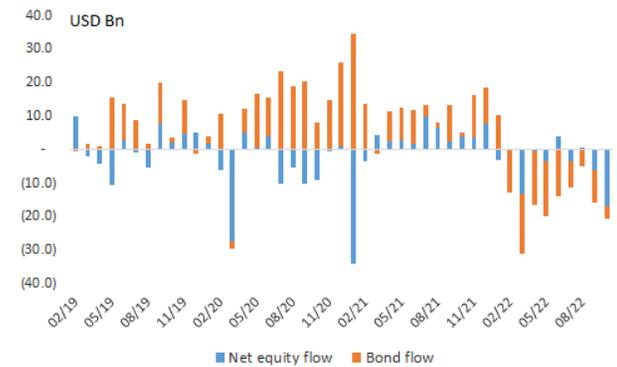
Negative China-US rate differential drove weaker RMB



Chinese Fixed income flows face stiffer global competition for inflows



Portfolio outflows accelerated

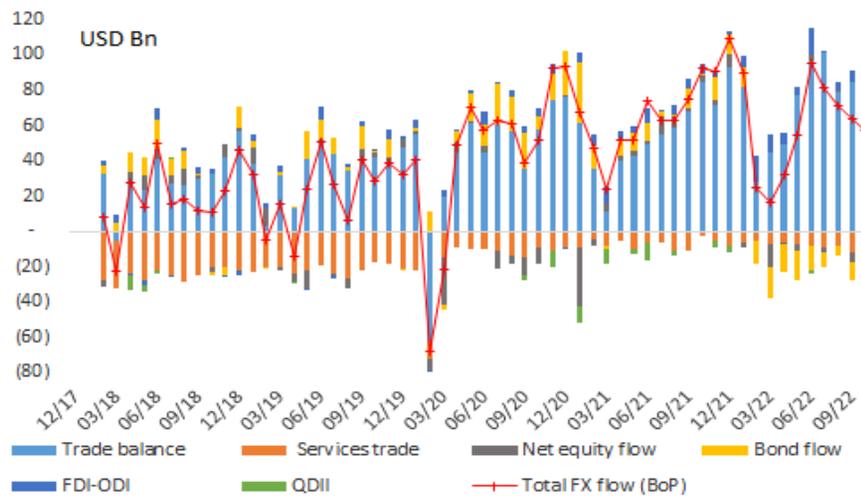


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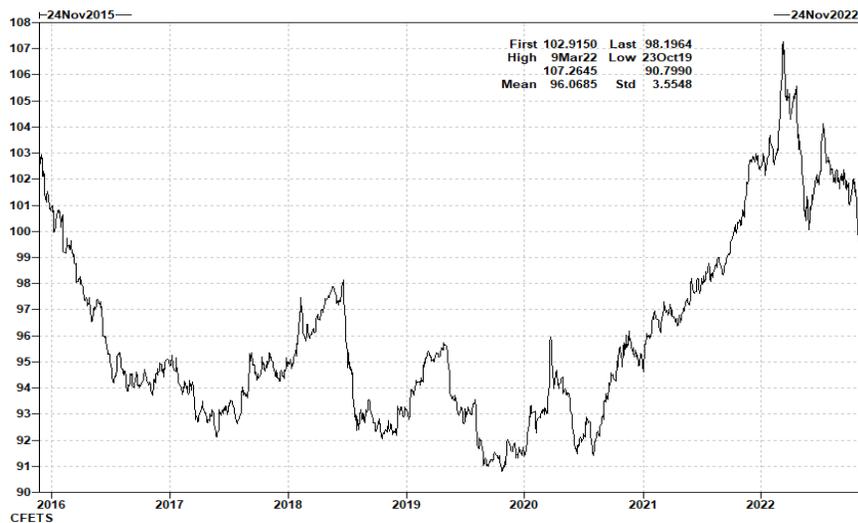
China developments and FX markets

Reopening to create BoP pressure in China, but demand for EM currencies

China reopening could deteriorate BoP - services deficit increase, trade balance decline



RMB CFETS index still has room to decline compared to history



China reopening may have greater impact on economies exposed to China

(Unit: Billion USD)	Exports to China in 2021	Exports to World in 2021	% of exports to China
Chile	37	94	38.9
Australia	130	344	37.7
Brazil	88	282	31.4
Peru	18	62	29.0
Taiwan	128	448	28.2
South Korea	163	644	25.3
Japan	164	758	21.8
Indonesia	45	232	19.3
Philippines	12	75	15.5
Saudi Arabia	54	290	18.8
Vietnam	55	329	16.7
Malaysia	48	299	15.5
Singapore	68	457	14.8
Russian	68	492	13.9
Thailand	37	268	13.7
South Africa	14	122	11.3
Israel	4	59	7.3
Switzerland	33	379	8.7
United States	151	1759	8.6
Germany	124	1632	7.6
India	23	395	5.8
United Kingdom	24	460	5.1
France	28	585	4.9
Canada	23	502	4.6
Euro Area	238	5457	4.4
Italy	19	610	3.0
Spain	10	384	2.7
Netherlands	19	838	2.3
Mexico	9	495	1.9
Belgium	10	545	1.7
Hungary	2	142	1.4
Czech Republic	3	228	1.3
Poland	4	338	1.1

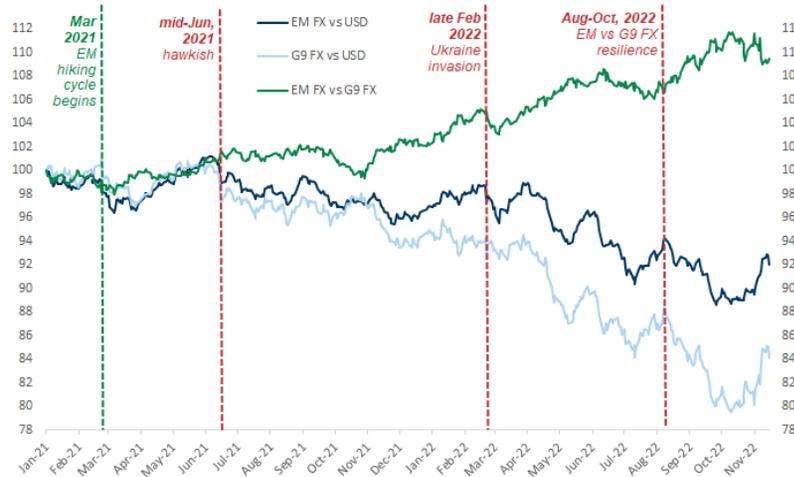
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EMFX performance and drivers

Relative resilience with Latam outperformance whilst CE3 struggles

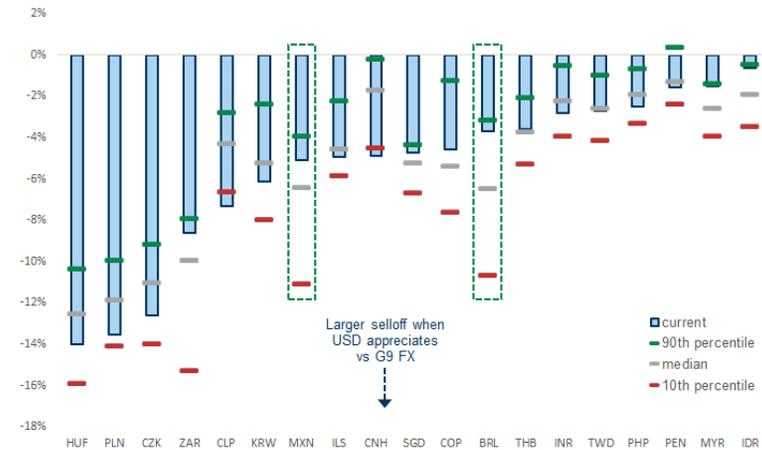
EMFX has been resilient so far, but the flipside is restrained upside in a dollar turn

Average total returns, indexed to 100 on January 4th, 2021.

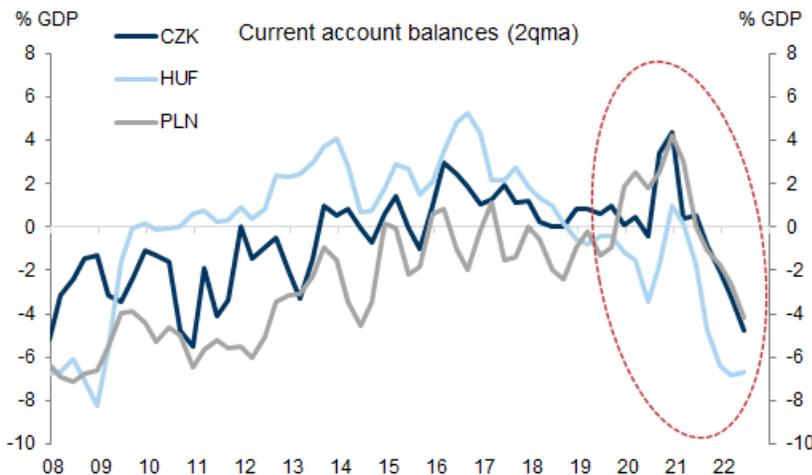


Relative to history, BRL & MXN have been resilient during periods of Dollar strength

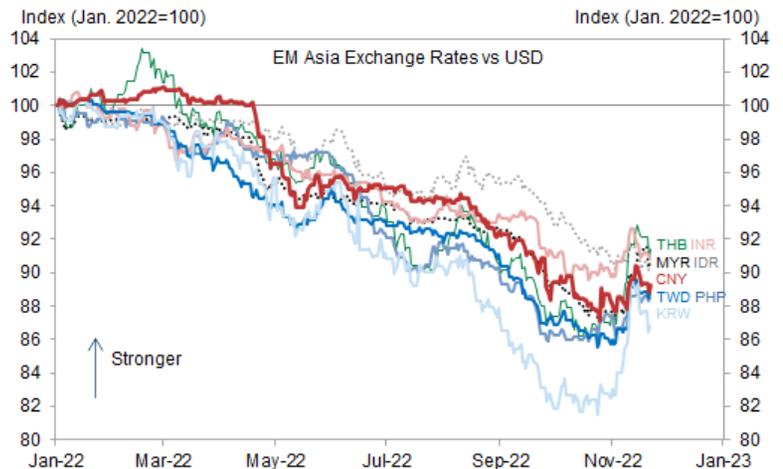
Estimated % appreciation of the displayed currency vs USD given a 10% appreciation in the USD vs G9 FX, using rolling 1-year samples estimated over the post-GFC period. Results control for a broad set of non-Dollar market factors.



CE3 external balances have deteriorated sharply, eroding valuations



Lesser pressure on Asia's interveners (INR, IDR, THB), but risk of reserves rebuild

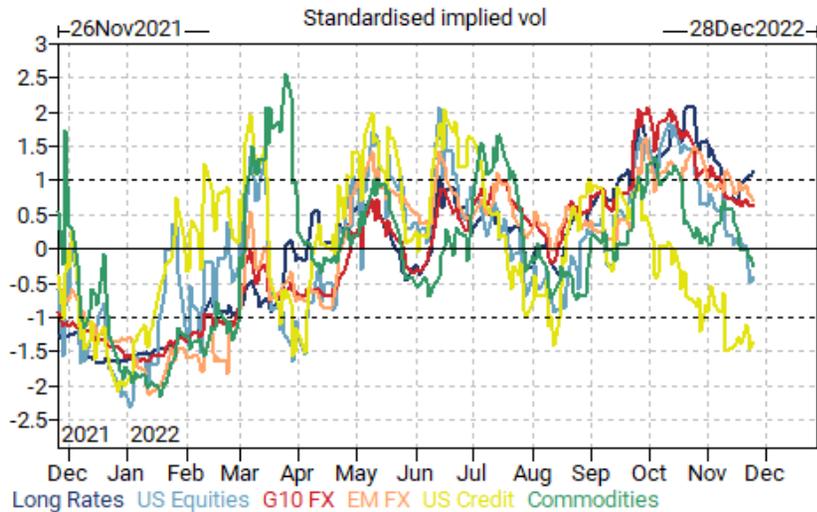


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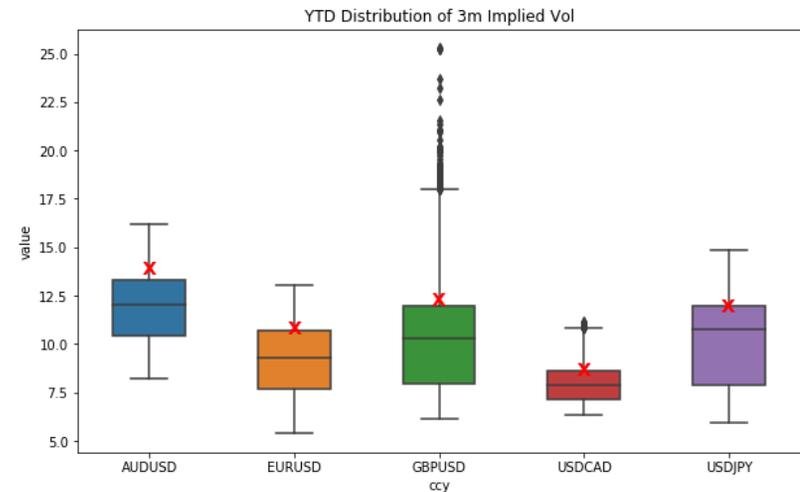
FX volatility market developments

Still elevated FX implied volatility; but not priced to revisit 2022 Dollar highs

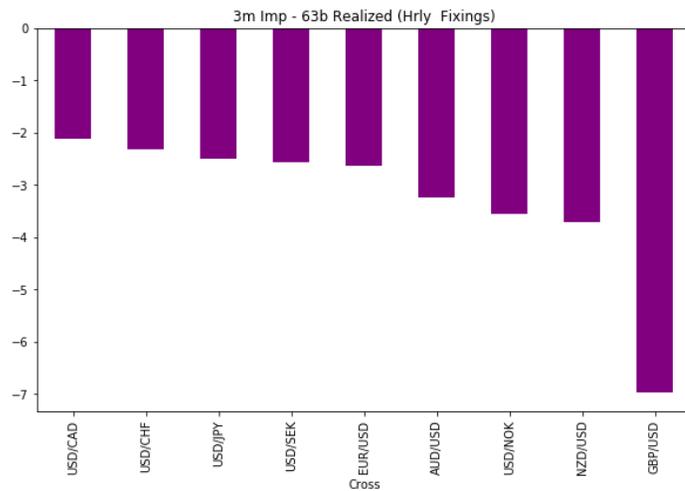
FX and rates vol remaining more elevated than equity and credit



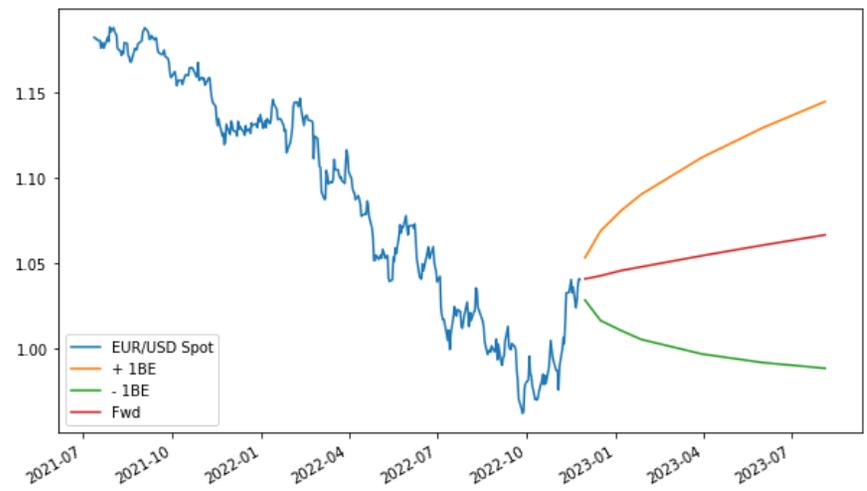
FX vol off the highs, but still in the top quartile YTD



High realised vs implied gamma performance across G10



EUR/USD not priced to revisit 2022 lows

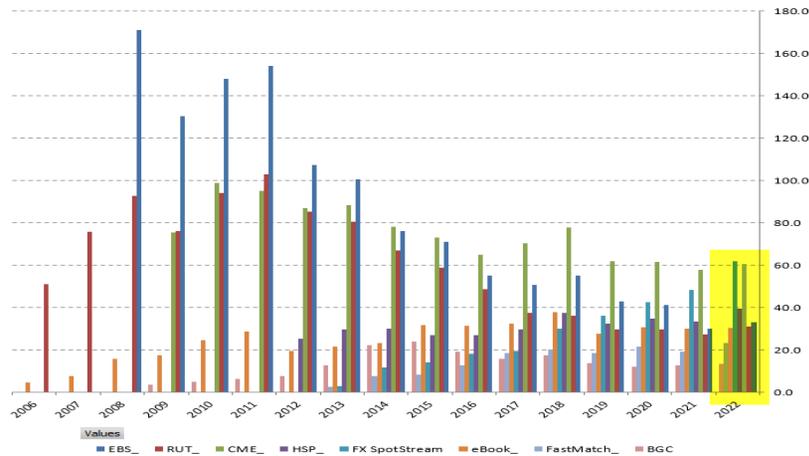


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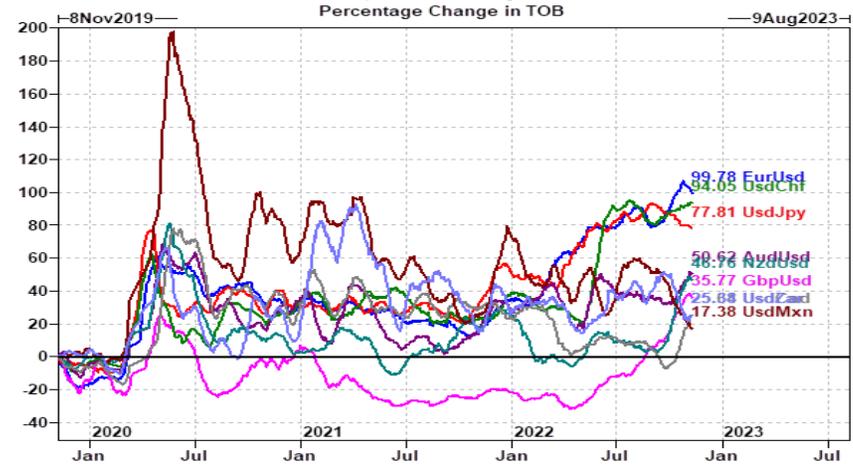
FX spot market structure developments

Disintermediation continues; volumes dropping amidst elevated volatility

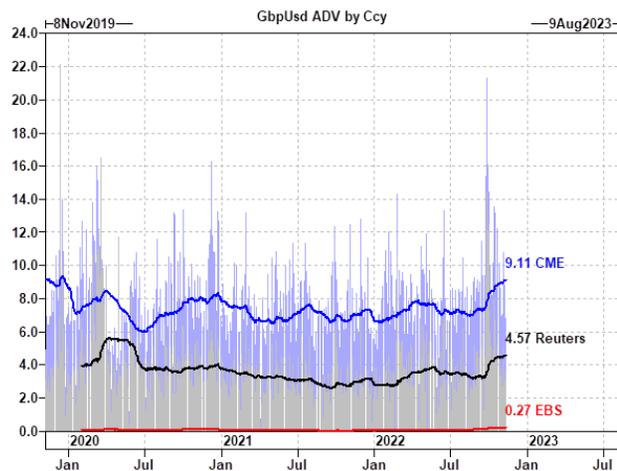
Disintermediation of primary venues continues



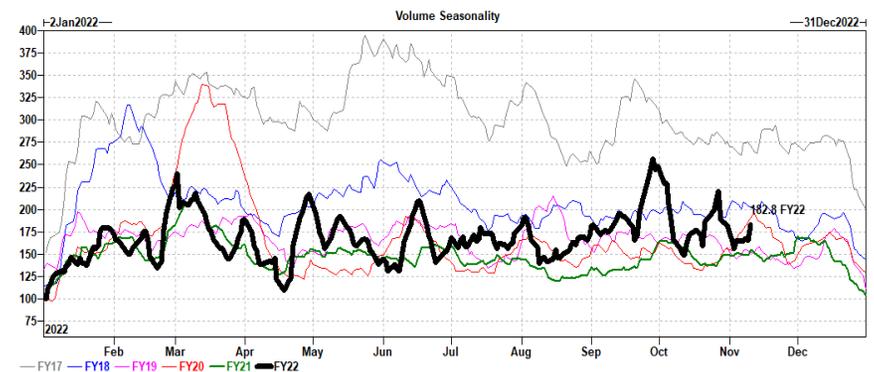
TOB Spreads moving wider



GBP Primary Market ADVs



Volume seasonality – notable drop in volumes to 2021 levels in early Oct/Nov yet volatility remained elevated



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Questions and talking points

-
1. Does the group expect the levels of implied and realised volatility observed in FX markets this year to continue into 2023?
 2. Have we seen the peak in pricing for G10 hiking cycles and how do we expect that to influence relative FX performance going forward?
 3. Are markets paying sufficient attention to the potential impact from QT?
 4. The drivers of FX performance this year have been quite clear and distinct. What do we expect to be the most dominant and impactful factors in 2023?
 5. Can the relative resilience in EM currencies (on a TWI basis) seen this year be repeated in 2023?
 6. What might the Chinese exit from Covid look like and what are its implications for the renminbi and global energy prices?
 7. Does the group expect the trend for disintermediation of primary venues to continue and with what implications?

References

Referenced publications by Goldman Sachs Global Investment Research

1. [European Economics Analyst: 2023 Europe Outlook: Milder Recession, Higher Terminal Rate, 16-Nov-2022](#)
2. [2023 Global Rates Outlook: Chasing Neutral, 21-Nov-2022](#)
3. [EM Macro Navigator: 2023 Outlook - Seeking a Better Growth/Inflation Mix, 28-Nov-2022](#)
4. [2023 Global FX Outlook: Waiting for a Challenger, 18-Nov-2022](#)
5. [EM Market Outlook 2023: Resilience Behind, Restrained Upside Ahead, 22-Nov-2022](#)

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