FX Themes and Trades
Monthly Outlook
March 1, 2021

Economics
FICC Strategy

FX Markets Reawaken With Vaccine Rollout

Currency — What's Changed

USD — USD depreciation to resume as the global economic recovery gains momentum.

CAD — Further loonie gains in the coming months, but BoC will out-dove the Fed and C$ will shed some strength in the second half.

EUR — An expected Q2 rebound, as well as mitigated political risks, underpin our view for euro strength.

GBP — GBP profile upgraded in the wake of UK negative rates being pared from the policy agenda.

JPY — Compressed yield spreads should continue to limit JPY outflows.

Commodity FX — Messaging from central banks against currency strength an area of caution for AUD & NZD.

LATAM FX — Monetary policy divergence favours BRL.

FX Asia — Details of the 14th five-year plan and the centenary of the founding of the Chinese Communist Party should open the economy further, suggesting appreciation of the yuan ahead.

Currency Outlook

End of Period:	Mar. 1/21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
USD/CAD	1.27	1.24	1.27	1.30	1.32	1.33	1.34	1.34
EUR/USD	1.20	1.24	1.26	1.26	1.25	1.25	1.24	1.23
USD/JPY	107	102	100	99	99	99	100	101
GBP/USD	1.39	1.43	1.46	1.46	1.44	1.43	1.41	1.40
USD/CHF	0.91	0.88	0.87	0.87	0.88	0.89	0.88	0.89
USD/SEK	8.48	8.07	7.90	7.82	7.84	7.80	7.82	7.85
AUD/USD	0.77	0.82	0.82	0.84	0.85	0.86	0.87	0.88
NZD/USD	0.72	0.75	0.75	0.76	0.77	0.78	0.78	0.79
USD/NOK	8.63	8.10	7.89	7.82	7.80	7.72	7.70	7.68
USD/ZAR	15.10	14.35	14.20	14.00	13.95	13.85	13.65	13.50
USD/BRL	5.59	4.80	4.80	4.50	5.00	4.80	5.00	4.50
USD/MXN	20.8	20.0	20.0	19.0	19.5	19.8	20.0	20.5
USD/COP	3608	3600	3600	3500	3400	3400	3300	3200
USD/CLP	723	780	780	720	750	740	720	680
USD/CNY	6.46	6.32	6.25	6.15	6.05	5.95	5.85	5.80
USD/KRW	1123	1090	1080	1070	1065	1055	1050	1040
USD/INR	73.6	72.2	72.0	71.5	71.0	70.0	69.5	69.0
USD/SGD	1.33	1.31	1.31	1.30	1.30	1.29	1.29	1.28
USD/TWD	28.1	27.3	27.1	27.0	26.9	26.8	26.7	26.6
USD/MYR	4.06	4.00	3.95	3.85	3.80	3.75	3.70	3.65
USD/IDR	14255	14000	13900	13800	13750	13700	13650	13600

Other Crosses

End of Period:	Mar. 1/21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
CADJPY	84.1	82.3	78.7	76.2	75.0	74.4	74.6	75.4
AUDCAD	0.98	1.01	1.04	1.09	1.12	1.14	1.16	1.17
GBPCAD	1.77	1.77	1.85	1.90	1.90	1.90	1.89	1.88
EURCAD	1.53	1.54	1.60	1.64	1.65	1.66	1.66	1.65
EURJPY	129	126	126	125	124	124	124	124
EURGBP	0.86	0.87	0.86	0.86	0.87	0.87	0.88	0.88
EURCHF	1.10	1.09	1.10	1.10	1.10	1.11	1.09	1.09
EURSEK	10.22	10.01	9.95	9.85	9.80	9.75	9.70	9.66
EURNOK	10.39	10.04	9.94	9.85	9.75	9.65	9.55	9.45

Key Indicators- Latest Data Point

	Quarterly Real GDP (y/y %)	CPI (y/y %)	Current Acct (% of GDP)	Central Bank Rate (%)
US	-2.4	1.4	-3.4	0.125
Canada	-5.2	1.0	-1.3	0.250
Eurozone	-5.1	0.9	2.0	0.000
Japan	-1.2	-1.2	4.8	-0.100
UK	-7.8	0.6	-2.9	0.100
Switzerland	-1.7	-0.5	5.2	-0.750
Sweden	-2.7	0.5	5.2	0.000
Australia	-3.8	0.9	1.9	0.100
New Zealand	0.4	1.4	-2.2	0.250
Norway	-0.6	2.5	2.1	0.000
South Africa	-6.0	3.1	5.9	3.500
Brazil	-3.9	4.6	-1.6	2.000
Mexico	-8.6	3.5	1.5	4.000
Colombia	-8.5	1.6	-3.3	1.750
Chile	-9.1	3.1	0.0	0.500
China	6.5	-0.3	2.0	3.850
South Korea	-1.4	0.6	3.8	0.500
India	-7.5	4.1	1.3	4.000
Singapore	-2.4	0.2	17.6	n/a
Taiwan	5.1	-0.2	12.7	1.125
Malaysia	-3.4	-1.4	4.4	1.750
Indonesia	-2.2	1.5	-0.5	3.500

CAD

Katherine Judge | Avery Shenfeld

C$: Rich Now, But Still Getting Richer

Q2 2021: 1.24 | Q3 2021: 1.27 (USDCAD)

The loonie touched its strongest levels since 2018 in the past month, as the greenback saw its strengthening trend stall out and a climb in the price of oil bolstered loonie momentum. Given higher levels of crude than previously assumed, and the persistence in the CAD's correlation with movements in the broader USD index, we now see scope for an appreciation in the C$ over the next few months, with USDCAD expected to sit near 1.24 at mid-year, and likely testing even lower levels in the interim. Simply put, momentum trading and enthusiasm for commodities currencies could swamp longer-term fundamentals, including a chronic trade deficit, that suggest that the C$ is already too rich for the economy's blood.

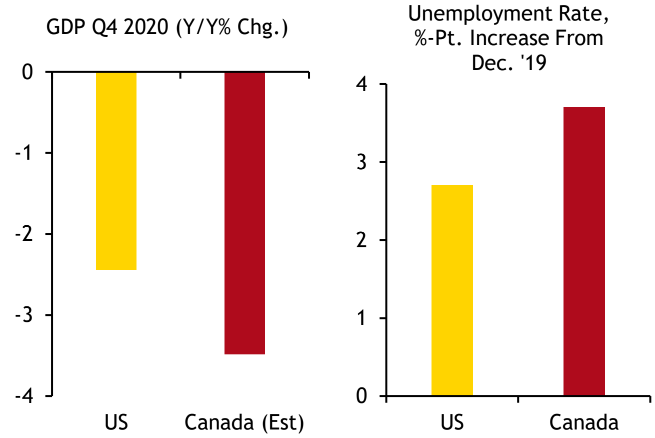
That said, we still see the loonie giving up ground late this year and into 2022. Having seen a larger contraction in 2020 (Chart 1), Canada has a tighter set of public health constraints in Q1, and a lag in vaccinations will widen the economic gap to the US in the first half of this year. Canada outgunned the US on fiscal stimulus in 2020, but the US looks set to deliver a proportionately larger boost this year.

The Bank of Canada's guidance that rate hikes could come in 2023 still looks reasonable, but the market is moving to price-in rate hikes at least six months too early, and we'll hear the BoC push back against that view. In part to quell C$ gains that it views as a drag on trade, the BoC will likely try to reinforce its dovish messaging at future announcements, noting that its framework is flexible in terms of allowing inflation to run above the 2% target on a temporary basis.

In contrast, the Fed is set to change its tune later this year, and will ultimately bring forward its tightening by a full year. That should help cool the loonie's fires, as will a bit of retracement in energy prices as OPEC+ supply rebounds.

Markets are also likely a bit too optimistic on the outlook for Canada's trade and current account balance. While oil's recovery will help, a headwind is coming from the return of cross-border tourism, where Canada runs a large deficit.

Chart 1: Canadian Economy Saw Larger Drop in GDP and Steeper Climb in Unemployment



Source: StatCan, BEA, BLS, CIBC

USD

Bipan Rai

Reawakening the USD Bears

Q2 2021: 88.2 | Q3 2021: 87.0 (DXY)

So far this calendar year, the trade-weighted greenback has been a sleepy story. We expect that to continue in the near-term as the market is still quite short USD. Additional tailwinds could also come from the recent rally in longer-dated Treasury yields, but we expect these to have a marginal effect on the USD given the current pace of the Fed's QE buying and that the costs to hedge for foreign asset managers are still quite considerable.

What could reawaken the USD bears is the influx of liquidity that's expected to come as Congress passes the upcoming relief bill. That should increase reserve balances on the Fed's balance sheet and pressure short-term rates lower by extension. From prior experience, we know that this can materially dent the USD against other currencies. Other long-term headwinds to the USD include the Fed's average-inflation framework, the diversification of foreign flows away from UST, and upcoming talks on digital taxes. While incoming data should be supportive, we expect the Fed to look past this in the near-term and for the USD to continue to trade defensively.

We'll need to wait until H2 2022 before we start to see the USD materially outperform against overseas majors on a sustained basis. That's tied to our view that the Fed will start tightening in 2023.

EUR

Jeremy Stretch

EUR To Strengthen With Vaccine Rollout in Q2
Q2 2021: 1.24 | Q3 2021: 1.26 (EURUSD)

The ECB remains concerned about the economic drag associated with euro appreciation. The market was earlier ignoring warnings that all instruments remain on the table, but the discussion surrounding an additional easing in the deposit rate has now come back on the agenda. With even avowed ECB hawk Klaas Knot underlining that the ECB has yet to reach the effective lower bound, as ECB studies suggest that it could be as low as -1.0%, we have seen investors paring EUR holdings back to early November levels.

Internal political recriminations, due to the bureaucratic response of the European Commission, have prompted a questioning of 2021 growth assumptions amidst a delayed vaccine rollout. However, despite the slow vaccine rollout, the ECB stands by their December staff forecasts, as they had already discounted a Q1 lockdown. With eurozone vaccinations set to pick up into Q2, we can expect a supportive macro backdrop, as external manufacturing sentiment has remained supported by Asian demand. An expected rebound in Q2, following an easing in lockdown restrictions, will sustain growth and inflation expectations, and thereby help put to bed the chatter about moving to an even lower deposit rate, lifting the euro in the process.

Our cautiously upbeat EUR view is also supported by the removal of Italian political risks. New Italian PM Mario Draghi comes into politics after spending eight years at the helm of the ECB. It appears that dealing with divergent central bank views from across the eurozone was good training for becoming Italian PM. The prospect of Draghi pushing forward with structural reforms to encourage a constructive use of EU rescue funds will benefit the zone, extending the compression in BTP-Bund spreads. Yield-based interest in Italian bonds remains EUR constructive. Moreover, Draghi's support for a common euro budget may encourage ongoing debate regarding fixing one of the long-term structural holes within the monetary union regime. Structural reforms and discussion of a reform of eurozone politics, under a Draghi/Macron alliance will help support medium run EUR valuations, at least against the other low yielders.

JPY

Jeremy Stretch

Narrow Yield Spreads Continue to Limit Yen Outflows
Q2 2021: 102 | Q3 2021: 100 (USDJPY)

Although the Bank of Japan modestly upgraded their inflation forecasts for fiscal year 2021, from 0.4% to 0.5%, that still leaves inflation well short of target. The BoJ's inability to reach their policy goal underlines why the bank are reviewing their policy tools, the results of which are set to be announced at the March 18-19th policy meeting. The Bank aims to make its policy assessment more effective, with the pandemic making meeting the inflation target even more challenging.

One interesting scenario from the BoJ policy review comes via the BoJ potentially considering extending negative rates. The BoJ could consider reminding the market that they could take rates further into negative territory if necessary. The assumption would be that such a policy would provide more room for manoeuvre, via an attempt to cheapen up the JPY, in order to reach their inflation target.

The BoJ have maintained rates at -0.1% for more than five years. Markets have assumed that the bank had little room to act, in large part as it would undermine financial sector profitability. Other central banks who operate negative rates, (ECB/SNB) face the same issue and accordingly shelter a portion of bank reserves from negative rates, mitigating their effectiveness, if lowering lending rates is the primary intention. Of course, if cheapening the JPY is the intention, the policy could prove more effective. However, we would expect the bank to avoid such risks unless the JPY were to become appreciably stronger than we assume over the next 12-24 months.

Another potential policy outcome could be the toleration of greater flexibility or a wider trading band in terms of yield targets. In terms of yield spreads, the premium on UST remains relatively modest, limiting net JPY outflows. This suggests the perpetuation of USD/JPY remaining confined to a 102-107 range in the near term, albeit with a downside bias.

GBP

Jeremy Stretch

Economic Recovery as Vaccination Continues Supports GBP Momentum

Q2 2021: 1.43 | Q3 2021: 1.46 (GBPUSD)

We have upgraded our GBP forecast profile in the wake of UK negative rates being stricken from the policy agenda. The combination of an upbeat BoE macro assessment, predicated on an accelerated vaccine rollout, and the avoidance of a no-deal Brexit, underlines that negative rate assumptions are not credible. Although we can expect policy inertia until H1 2023, the consequence of the removal of negative rate assumptions will be a steeper curve, as CPI heads back to target, while activity levels accelerate. Barring an exogenous shock to the UK vaccine strategy, as almost 30% of the adult population have been vaccinated, expect Sterling to have moved into a new, higher paradigm.

Although the UK economy is set to suffer a material contraction in Q1 due to the impact of a third national lockdown, the BoE still assumes that the economy will end the year in line with previous estimates. Consequently, the BoE anticipates quarterly growth averaging in excess of 3% for the rest of 2021, despite job shedding as the furlough scheme winds down. The Bank has attempted to be cautious in their consumer spending assumptions. Using limited evidence from Australia and New Zealand leaves them assuming a moderate rebound in consumer spending. Estimates point towards UK consumers having increased savings by around £125-150bn, equal to around 10% of total 2020 retail spending. That provides ample fuel for consumption to run ahead of BoE projections.

A period of excess demand, would under more normal circumstances encourage markets to price in higher administered rates. However, as GDP is set to remain below pre-Covid levels into 2022, the underlying dynamics are far from normal. Still, a vaccine inspired, consumer-led recovery from Q2 onwards, obviates the need for negative rate risks, so the prospect of higher inflation and accelerating growth supports a stronger performance in trade weighted Sterling.

CHF

Jeremy Stretch

Safe-Haven CHF to Weaken as Global Recovery Accelerates into Mid-Year

Q2 2021: 1.09 | Q3 2021: 1.10 (EURCHF)

Switzerland may be witnessing a faster vaccine rollout than near neighbours, such as Italy, Germany and France, but that will not preclude the economy from seeing challenges extend into 2021, as Q1 will prove compromised by lockdown measures.

Although the macro fundamentals remain challenging, excepting the slightly faster vaccine rollout, it is not the near-term fundamentals that have left the CHF as a net underperformer. In a reflationary world, the low-yielding CHF remains something of an underperformer, particularly versus high-yielding EM currencies, such as the TRY and ZAR. The broad reflationary bias, predicated upon a return to solid global growth, boosting commodity or growth-orientated currencies, should continue to ease the job of the SNB. The national central bank remain orientated towards limiting CHF gains, to maintain export competitiveness and limit disinflationary pressures.

An easing in global risk dynamics reduces the allure of safe haven currencies, much to the relief of the SNB. Over the last couple of months, the relatively stable SNB sight deposit data suggests that the SNB have been able to largely sit on the side-lines. Nevertheless, the central bank would no doubt prefer to see a faster pace of CHF depreciation. We do expect the Swiss currency to modestly depreciate towards the 2 year (1.09) moving average versus the EUR, into mid-year.

SEK

Jeremy Stretch

Swifter Recovery Ahead Could See Tightening Earlier Than Priced In, Leading SEK Gains

Q2 2021: 10.01 | Q3 2021: 9.95 (EURSEK)

The Riksbank currently view their greatest policy risk as moderating their ultra-easy policy too quickly. As a consequence, the bank currently maintains a bias towards holding rates at current levels, (zero) until 2024. Moreover, central bankers are keen to leave the option of negative rates in the policy toolbox. Central bank caution is perhaps less surprising when you consider that unlike most other jurisdictions, Sweden is currently facing its most severe Covid restrictions.

Despite the bank remaining wary of an early policy adjustment, the underlying data, allied to the forward looking macro assumptions, appear inconsistent with long term policy inertia. Positive forward survey dynamics are demonstrated by the composite PMI breaching the 60 threshold in January for the first time since June 2018. Four straight monthly gains underline why central bank Governor Ingves views the economy as proving more resilient through the second wave of the virus.

Although the central bank are intent on portraying an extended period of policy inertia, underlying macro variable suggest earlier action, validating ongoing SEK gains. The ongoing positive correlation between the SEK and broad risk dynamics, including domestic stocks, suggests a perpetuation of the broad reflationary environment will prove constructive for the SEK.

Sweden, like many EU members, has been slow in terms of initial vaccine rollout. However, an acceleration into H2 should help validate supportive growth prospects extending into 2022. As a consequence, the recent central bank downgrade to 2022 GDP looks overly cautious. Risks to the forecast are clearly to the upside, impacting output gap expectations. Therefore, we anticipate the market looking to price in earlier tightening, prior to the end of next year, supporting the SEK. This comes despite the central bank continuing to preach policy patience.

Commodity FX

NOK

Jeremy Stretch

NOK Set to Be Top Performer During Global Recovery

Q2 2021: 10.04 | Q3 2021: 9.94 (EURNOK)

The Norwegian economy continued to surprise to the upside into the end of 2020. Quarterly mainland GDP expanded by 1.9% in Q4, well above 1.3% median expectation. Moreover, concerns regarding a second wave of infections undermining late year activity proved overstated as December showed a 1.0% gain in GDP. A solid H2 rebound, which extended into year-end, underlines the presumption of robust residual momentum being carried into 2021. We would expect the strong impetus to offset worries over the slow pace of domestic vaccine rollout undermining Q1 activity.

The strong H2 momentum generated within the Norwegian economy left the economy a mere 2.5% smaller than 2019 levels, this compares to the Norges Bank estimation of a 3.5% differential. The more modest shortfall compared to central bank expectations implies a smaller than expected output gap, impacting the monetary policy outlook.

The Norges bank continues to be regarded as a likely first mover when it comes to central bank policy tightening. The bank currently anticipate a monetary policy reversal from Q1 2022. However, a smaller than expected output gap and supportive forward looking variables suggest the probability of an earlier move should continue to grow. With the combination of a milder than expected downturn and a strong 2021 rebound, look for oil sector impetus to underpin employment and consumption growth, favouring a move in H2 this year, not early 2022.

Beyond the output gap, robust credit growth likely necessitates earlier tightening. Expect a solid employment backdrop to encourage growth to rebound towards 2019 extremes, when annual rates reached 6.0%. The combination of an earlier than expected tightening, underpinned by consumption growth and positive oil sector dynamics, maintains a bias towards strong NOK performance. In a reflationary world, expect the Norwegian Krone to be a top performer.

AUD

Patrick Bennett

Extending Already Strong Gains

Q2 2021: 0.82 | Q3 2021: 0.82 (AUDUSD)

Our positive outlook targeted AUD/USD initially to 0.7850 at end-1Q. That level has now been reached and comfortably exceeded. We now anticipate further gains and forecast 0.8150 at end-2Q. Below, we review expectations that got us here and influences to come.

At a base level, we saw a combination of rebounding domestic activity and much improved trade and current account positions underlining gains in the AUD. Those factors have been sustained and now strengthened, particularly under the influence of global reflation enthusiasm and on a broad rally in commodity prices.

On monetary policy, we saw the accommodative stance of the RBA - reducing the cash rate, term-funding, and anchoring 3-year yields, all at 10bps, as arresting downturn risks and supporting activity. That in turn supported assets and promoted demand for the currency. Policy support has been confirmed to remain for some time yet, and absent a downturn, the positive trend for the AUD should remain intact.

Ahead of QE being introduced in November of last year, Australian bonds offered near the highest yields in G10. Portfolio inflow had been strong to that time, and has remained so. While RBA desired QE to cap yields and keep the currency weaker than it would otherwise be, other central banks were pursuing similar programs. The net result was that the yield advantage was barely dented, and is now more than restored. AUD yield support is now greater than previously, as the rise in global yields has been sharper in Australia than other major markets (New Zealand excepted). Japanese investors were and remain strong buyers of Australian bonds. The rally in AUD/JPY reflects some of that flow.

We expect ongoing yield demand to keep the cross firm. We are aware that AUD levels risk reaching a point that could raise the ire of the RBA. We don't believe we are there yet. Referencing commodity prices and interest rate differentials as indicative, Assistant Governor Kent last week suggested the currency was as much as 5% lower in trade-weighted terms than it might otherwise be without Australia's monetary stimulus and QE. That confirms there is potential for gains, and also provides a reference. We judge the trade-weighted value relationship with terms-of-trade showing a discount of near 10%. Another 2-3% gain with AUD/USD higher still leaves plenty of room for the RBA to be comfortable, still well within a very long-held relationship, and still able to talk of a currency being 'weaker than it would otherwise be'.

NZD

Patrick Bennett

Further Gains as Activity Recovers

Q2 2021: 0.75 | Q3 2021: 0.75 (NZDUSD)

NZD/USD has performed strongly in the first two months of the year, extending a strong finish to the previous year and now to levels last seen in 2018. We see NZD continuing tracking to stronger levels as the economy rebound continues and global reflation pricing supports commodity prices, though we doubt the same pace of gains seen to date will be repeated over the next quarter.

Gains in the NZD have been underpinned by a strong rebound in domestic activity, that in turn has been supported by accommodative monetary and fiscal policy. RBNZ, as other central banks have done, has reconfirmed its commitment to keep policy accommodative for some extended time. The recent backing up in global yields sees NZ bond yields near the highest in G10, and we expect that fact to attract portfolio flows and support the NZD.

RBNZ, like the neighbouring RBA, have stated the currency is weaker than it would otherwise be due to accommodative policy. We note that, though question that it does not allow the NZD to strengthen further? Further, we doubt there are tools available to change the NZD outcome over more than the short-term. We forecast gains for the NZD against the USD and JPY, and some underperformance against the AUD.

ZAR

Jeremy Stretch

ZAR Gains Supported by Attractive Yields

Q2 2021: 14.35 | Q3 2021: 14.20 (USDZAR)

The combination of extended global central bank liquidity, US fiscal stimulus and vaccine optimism are benefitting global recovery tendencies. Such a backdrop has proved favourable for high yielding EM currencies. As a consequence, we have seen ZAR prove a material outperformer, gaining 3.7% against the low yielding Greenback in just a month.

Relative ZAR outperformance is all the more impressive as real money speculative longs have halved since late December. Moreover, a Covid second wave impacted output in the first part of Q1. Ongoing electricity outages, power supply concerns are likely to persist throughout H1, underlines near-term GDP headwinds. High frequency spending data had shown signs of weakness even before the return of level 3 (lockdown) restrictions. Such restriction have been removed amidst a collapse in domestic Covid cases.

Although the government's vaccine strategy has been compromised by the AstraZeneca vaccine proving relatively ineffective against the local Covid mutation, the government soon anticipates reaching adequate supply. Mass vaccination programme challenges suggest there is a considerable risk that the government does not achieve widespread vaccination success until early 2022.

A slowing economy and an uncertain start to the vaccination process do not appear to make a particularly compelling case for investors. Yet despite such headwinds, external investors continue to favour the attractive yield pick-up. Ongoing yield-based attraction, South African real 10-year yields currently remain in excess of 5%, underlines why we have seen the three month moving average of foreign purchases of domestic bonds testing towards early 2016 highs. Until the global reflation narrative is materially threatened, either by concern over vaccine efficacy or an unexpected policy response despite underlying macro headwinds, we can expect investor appetite to continue to sustain the ZAR.

LATAM FX

MXN

Luis Hurtado

Banxico Removes Cautious Tone

Q2 2021: 20.0 | Q3 2021: 20.0 (USDMXN)

In a unanimous decision and in line with our forecast, Banxico cut the overnight rate by 25bps to 4.0% on February 11th. Despite inflation expectations edging a bit higher, the Central Bank moved away from its cautious tone on high core prices, and the recent spike in inflation. Moreover, it mentioned that the current inflation trajectory remained within its latest forecast and that it remains likely to drop during the second semester. The statement also anticipated an ample output gap through its monetary policy horizon and repeated that the risks to growth are tilted to the downside.

Regarding currency action, USD/MXN approached and briefly jumped above the 21.00 mark driven by the move in US treasuries. The move was contained by Banxico's announcement to maintain the extraordinary measures (implemented last year) that provide liquidity and support markets until September 30, 2021. Although by itself nothing unexpected, the timing of the announcement signals that the CB could once again intervene in episodes of exacerbated volatility as the one experienced in late February. However, with Banxico's minutes still suggesting space for further rate cuts, and US yields at current levels, we would let the dust settle before reassessing our USD/MXN view for the remainder of the year.

BRL

Luis Hurtado

Interventionism Increases BRL Nervousness as New Spending Cap is Discussed

Q2 2021: 4.80 | Q3 2021: 4.80 (USDBRL)

The increase in US treasury yields and Bolsonaro's decision to fire Petrobras CEO on February 19th pushed USD/BRL above 5.50 in the last week of February. The decision to terminate was driven by discrepancies over increases in diesel and gasoline prices. This situation has increased the uncertainty that already surrounded the fiscal reform discussions tied to the negotiations of a new emergency aid package in congress, and has added a new risk layer to our BRL forecast.

On the monetary policy front, we had already forecast a 25 bps rate hike in March and 150 bps in rate hikes by the end of 2021, in line with the recent inflation spike and the removal of forward guidance that called to prolong low rates. However, the events of this week have pushed us to reassess the path of Selic rate increases for the rest of the year. Although the removal of the Petrobras CEO could help to lower pressure on prices, it also indicates increased government interventionism and downward pressures on the BRL. In our opinion, this is a situation that should lead to a more aggressive monetary tightening cycle. Hence, we now expect the BCB to increase rates by 200 bps in 2021, and we wouldn't discount the possibility of a 50 bps rate increase at its March 17 meeting.

Given recent events, we do not expect USD/BRL headline volatility to dissipate until at least the second half of March. However, details of the fiscal reform to be tabled next week suggest automatic spending control measures will remain on the agenda in exchange for the approval of a smaller (than last year's) extra-cap emergency aid. Moreover, we do not anticipate the imminent departure of Finance Minister Guedes, while the central bank appears to be willing to intervene as USD/BRL jumps above 5.50. We maintain our recommendation to sell USD/BRL on spikes at 5.50 with a 5.10 target and a 5.70 stop loss.

CLP

Luis Hurtado

Not Much Juice Left in the CLP

Q2 2021: 780 | Q3 2021: 780 (USDCLP)

Not much has changed in Chile, the BCCh kept the overnight rate at 0.5%, in line with our call and market expectations. The communique restated that the Central Bank will remain on hold at 0.5% for most the monetary policy horizon (2 years) and that it is willing to maintain its unconventional measures (extended Conditional Financing Facility (FCIC) for sixth months and continue its bank bond buying program).

With regards to USD/CLP, we see it forming a strong floor within the 700-720 range, driven by higher copper prices and early access to vaccines in the region. Nevertheless, we expect the CLP to have limited room for further gains as a prolonged electoral cycle (constitutional assembly, general elections) remains the primary risk.

COP

Luis Hurtado

COP Appreciation Limited by Fiscal Risks

Q2 2021: 3600 | Q3 2021: 3600 (USDCOP)

Banrep maintained the overnight rate at 1.75%, however, two out of the seven board members voted in favour of implementing a 25bps rate cut. The statement left the door open for final rate cut as headline inflation remains below target. Moreover, The central bank lowered its 2021 GDP growth estimate to 2%-6%, from the previously estimated 3%-7%. The bank also lowered its inflation forecast for this year to 2.3% from its previous 2.7% forecast. The revisions support our expectations of a final 25bps rate cut in March, and the resumption of a rate increases only in late 2021/early 2022.

The possibility of a credit rating downgrade out of the investment grade space is likely to prevent a rapid appreciation of the COP this year despite the recovery of oil prices. Note that the country still needs to embark on a 2% of GDP fiscal adjustment by 2022 to comply with its fiscal targets and stabilize the country's debt burden. In our opinion, this task remains difficult to achieve considering the lack of support for significant tax reform, the focus of political parties on the 2022 election, and the optimistic 2021 Budget assumptions.

We see space for a USD/COP tactical move higher towards the 3650 mark. Moreover, for the rest of the year, we see any potential appreciation of the COP, driven by an improvement of the external picture and Covid-19 vaccine progress, to be limited by the country's fiscal risks. Hence, we maintain our year end USD/COP forecast at 3500.

Asia FX

CNY

Patrick Bennett

CNY CNH: Yuan Gains in Year of the Ox

Q2 2021: 6.32 | Q3 2021: 6.25 (USDCNY)

China has entered the Lunar Year of the Ox. Though modern Chinese financial market history is in its infancy, compared to the Chinese lunar calendar, the Year of the Ox (or bull) has previously been associated with positive market results. The last Year of the Ox in 2009-2010 saw a 51% rise in the Shanghai Composite Index. In the cycle before that, of 1997-1998, a 27% rally was recorded. We are not suggesting causality. Though after an uncertain year in 2020 and with markets already setting up for a better 2021, might the Year of the Ox be another positive one?

Even aside from any lunar new year influence, we have a positive outlook on the Chinese economy and the currency, and have recommended and expressed that via long positions in CNH. Recent PBoC liquidity management, and ongoing strong inward portfolio and FDI flows that are contributing to currency gains, reinforce our positive view. PBoC responded to economic uncertainty and curtailed activity arising from the COVID virus by adding liquidity to the economy. In China's case, the expansion of the money supply (M2) was somewhat subdued, certainly more conservative than the experience of 2008-09. Growth of M2 is currently around 10% y/y, while in 08-09 it reached near 30%. One implication is that less mopping up of excess liquidity will now be required.

A recent backing up in domestic rates heading into the lunar new year holidays was not the beginning of that process. Our view is that a correction to excessively easy monetary conditions was appropriate. It was part of stabilising overall liquidity ahead of holidays, and also potentially signalled a desire to curb leveraged positions in markets. We raise the liquidity picture as the management of it to-date has been as we might expect. Though any anxiety that policy tightening may continue would be a headwind to our bullish view.

PBoC recently released its 4Q monetary policy report, and in it reiterated an overall tone of stability. Liquidity will be kept 'reasonably ample' but not 'flush', and there will be no sharp turn in monetary policy. A tighter monetary policy in China than other major economies has not been so tight as to curb a recovery, but has been a support for the currency against other majors. We expect that to continue. The yuan has been stable to strong since mid-2020 and we forecast further gains this year and next. To any degree that the Year of the Ox encourages consumers and investors, we see markets taking it in stride and maintaining CNH gains.

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