Daiwa Securities

Daiwa's View

Forex outlook for 2023

➢ Corrections to dollar appreciation

Fixed Income Research Section
FICC Research Dept.

Senior FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp

Strategist
Kengo Shiroyama
(81) 3 5555-8755
kengo.shiroyama@daiwa.co.jp
Daiwa Securities Co. Ltd

Forex outlook for 2023

Corrections to dollar appreciation

The Russian invasion of Ukraine in February 2022 accelerated dollar appreciation that had started in mid-2021. US yields rose due to the Fed's monetary tightening at an unprecedented pace, and purchasing of the dollar intensified driven by the hawkish path taken by the Fed. However, it is highly likely that such movements have ended, reflecting weaker-than-expected US CPI for October (announced on 11 Nov). In late October, the market suddenly sensed that the pace of rate hikes by the Fed was slowing and dollar appreciation was ending. Now, with inflation having obviously slowed, appreciation of the dollar has clearly peaked out.

Thus far, the dollar has strengthened due to the Fed's hawkish stance reflecting higher inflation and the resulting rise in yields. Essentially, inflation is synonymous with deprecation of the currency value. Therefore, if the rise in yields has run its course, that means we will be more likely to see reactionary movements. However, the stance taken by the Fed will be the critical factor for US yields in 2023. We anticipate that the Fed will suspend rate hikes in March and start cutting rates in November. The US long-term rate is expected to decline to the neutral level towards end-2023 in line with the change in the Fed's stance (refer to our report *US yield outlook for 2023* dated 27 Dec 2022), and corrections to dollar appreciation in the forex market are likely to continue during this process.

Moreover, it is possible that the timing of rate-hike suspension and the start of rate cuts could both be delayed by one quarter. At this point, personal consumption and the labor market in the US remain firm, which is serving as a factor for sticky inflation for wages and services. The timing of the pivot by the Fed as well as the decline in intermediate/long-term US yields will change depending on when the cumulative effects of monetary tightening take full effect, after a bit of a time lag.

The main factor behind the shift in dollar appreciation is the fact that the market developed a strong sense that rate hikes by the Fed were peaking. However, other currencies must play a role in order for dollar appreciation to be corrected. In that sense, two factors—(1) easing of the terms-of-trade shock in Europe and (2) China's shift from its Zero-COVID policy—are likely to play important roles in pushing down the dollar. The shift in China's policy appears to be a particularly important change. In 2022, each time Chinese cities were locked down due to the spread of COVID-19 infections, there was concern about downward pressure on economies in other nations via slower growth in China. This exacerbated the situation in which the US economy emerged as the sole winner. The rise in the USD/CNY rate caused by concerns about slowdowns in the Chinese economy also appears to have added momentum to the trend towards dollar appreciation in the forex market overall.

The euro, which ranks second in the world after the dollar, is quite important in forecasting the dollar rate. Last year, the euro fell below parity against the dollar. The energy crisis triggered by the Russian invasion of Ukraine caused depreciation of the euro. However, the terms-of-trade shock is easing, as explained later in this report. Since it will take time for the energy crisis to be resolved, it is difficult to tell what will happen. However, the headwinds working against the euro are weaker than before. If the euro were to become firm once more, that would help to support a correction to dollar appreciation.

◆ JPY

In 2022, the fluctuation range for the USD/JPY rate was Y38.48 (highest: Y151.95, lowest: Y113.47), the largest since 1998. Furthermore, towards the year's end, the yen recovered rapidly from a weak level. Developments were quite volatile, as shown by the nearly Y20 appreciation of the yen towards the end of the year from its weakest level in October.

Since 2021, there has been a correlation between the USD/JPY rate and the Japan/US interest rate differential, with the rate being influenced by the Fed's monetary policy for a long period of time due to the lack of action taken by the BOJ. However, with the BOJ having unexpectedly modified its policy at end-2022, we now need to consider Japan's monetary policy as a factor affecting the USD/JPY rate.

As the BOJ widened the trading band for the long-term interest rate in December 2022, JGB yields rose mainly in the long-term zone. As long as speculation about BOJ policy revisions linger, JGB yields are viewed as less likely to decline. We anticipate that the BOJ will conduct a comprehensive assessment towards autumn, and then make further modifications to YCC or end YCC after the new governor takes office in April. If so, JGB yields are expected to rise temporarily, despite a decline in US yields. However, JGB yields are likely to shift downwards if global yields decline after the Fed starts to cut rates (refer to our report *JGB yield outlook for 2023* dated 11 Jan 2023).

With speculation about further policy revisions in the near term tending to mount, mainly among overseas market participants, we are likely to see movements towards higher yields and a stronger yen in the short term. However, given the true value of Japan's economy, we do not think that much upside potential for higher yields will remain even after the end of the YCC policy. We forecast that the focus will shift to conventional market fluctuation factors, such as a decline in US yields, in line with a gradual reduction in Japan-specific factors affecting forex rates.

That said, as has been reported in the media regarding revisions to the joint statement between the government and the BOJ, going forward there could be a review of the joint statement, as well as the ideal price target. If the price target were lowered from the current 2% or it were changed to a range, this would mean a shift from Abenomics and unprecedented monetary easing. This could increase pressure towards appreciation of the yen.

Pressure towards depreciation of the yen is also likely to ease in terms of supply/demand factors. Japan's trade deficit started to widen around the summer of 2021, and it increased rapidly from the spring of 2022 due to soaring energy prices, which gained momentum with the war in Ukraine. The shift from a trade surplus to a trade deficit has changed the supply/demand structure of the JPY market, serving as structural pressure to sell the yen.

It is rising imports that are widening the trade deficit, mostly because of rising import prices rather than rising import volume. Energy and other commodity prices peaked in June and the impacts of that should show up in import prices after a lag. Although the cutback in production by OPEC Plus may slow the decline in oil prices, that effect will not last long because it is concerns over a global economic slowdown that are causing crude oil prices to weaken. In that case, we expect Japan's record-high trade deficit has already peaked and its downward pressures on the yen via supply-demand will weaken.

The recovery of inbound demand is another factor working in favor of improving supply-demand in the JPY market. Border restrictions implemented early in the pandemic caused a sharp decline in the number of foreign tourists entering japan, and the consequent worsening of the travel account was another factor weakening the yen in 2022. However, Japan has already significantly eased its border restrictions, which in principle should restore inbound tourism to previous levels, and the number of foreign visitors has already started to recover. China, which previously accounted for about 30% of Japan's foreign visitors, recently eased its Zero-COVID policies, and Chinese tourists are expected to gradually return. Although it may take a while longer before inbound demand recovers to its pre-pandemic levels, we expect yen-buying pressures from foreign visitors began strengthening in 2023.

◆ EUR

Although the EUR/USD temporarily dropped below parity last year, the biggest reason for the euro's softening was the energy crisis. As the war in Ukraine dragged on and relations with Russia worsened, the supply of gas from Russia via the Nord Stream 1 undersea pipeline was cut off. The energy crisis has been hurting the euro zone's terms of trade, and in March 2022 its current account balance (seasonally adjusted) turned to deficit for the first time in a decade, going back to February 2012.

This was largely owing to a sharp rise in imports caused by rising oil and gas prices, but gas prices have recently dropped back to where they were prior to Russia's invasion of Ukraine. Helped by mild winter and European countries' efforts to reduce their gas consumption, the euro zone's current account balance improved almost to the point of a surplus in October. This is improving euro supply-demand and boosting the value of the euro.

Although the ECB decided to start slowing its pace of rate hikes at its Governing Council meeting in December 2022, it noted in its written statement that it "judges that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target," and also indicated plans to start shrinking its balance sheet in the beginning of March.

At her post-meeting press conference, ECB President Christine Lagarde sounded very hawkish, saying that the ECB is not pivoting, expects to raise rates by another 50bp at the next meeting, and may raise rates further at subsequent meetings. The eurozone economy is expected to enter a technical recession by recording two consecutive quarters of negative growth, in Oct-Dec 2022 and Jan-Mar 2023, putting it on the verge of stagflation. Because it will be difficult to continue buying the euro in the context of rate hikes while the economy is weak, we expect factors on the US side that correct dollar strength to cause a gradual increase in the EUR/USD.

◆ GBP

At the December 2022 meeting of its Monetary Policy Committee, the Bank of England raised its bank rate by 50bp to 3.5%. It noted that further "forceful" tightening will be necessary because the labor market remains tight amid strong increases in both prices and wages. Two members of the MPC, Swati Dhingra and Silvana Tenreyro, voted to leave the policy rate unchanged because of falling real incomes and weakness in the real economy caused by tight monetary conditions. The BOE is shifting to a more dovish stance.

Real GDP in the UK declined q/q in Jul-Sep and the economy may already be in recession. This is probably one reason why the BOE is expressing more concern about the economy than the Fed or ECB are. On 9 January, Huw Pill, the Bank of England's chief economist, pointing out the risk of inflation persisting because of rising natural gas prices and a tightening of the labor market, said rate hikes were likely to continue, as was indicated at the December policy meeting.

Strikes demanding wage hikes in response to high inflation have erupted across the UK, and the number of work days lost in October 2022 reached its highest in 10 years. In response, the UK government announced legislation on 10 January to limit strikes by workers providing public services. Because the legislation, if passed, will limit strikes in the public sector but do nothing to limit strikes in the private sector, the number of workdays lost will not decline unless inflation subsides, and this will likely raise uncertainty regarding growth and inflation.

Economic worries have been worse in the UK than they have been in the US or EU recently, and this is also contributing to differences in their monetary policy stances.

Consequently, with the trend in the dollar having changed, the GBP should steadily rise against the USD but is likely to weaken against the other major currencies over the near term.

◆ AUD

The Australian dollar started strengthened in December on the ending of China's Zero-COVID policy and is being boosted by the rise in iron ore prices on expectations of China's reopening.

Additionally, the foreign ministers of Australia and China met on 21 December 2022 and relations between the two countries appear to be improving. One result of the meeting was an announcement by China on 4 January that it would allow the resumption of imports of Australian coal, which had been unofficially banned. Although the value of Australia's coal exports to China prior to the unofficial import ban was not as high as the value of its iron ore exports to China, this will improve supply-demand for the AUD.

China's composite PMI has declined into the lower 40s, a level indicative of recession. If the European and US economies also slow, commodity prices are likely to soften, and this would reduce supply-demand support for the AUD.

US interest rates are declining in anticipation of Fed rate cuts, however, and this should push the AUD/USD higher. The Reserve Bank of Australia had been more dovish than the Fed, which had given it less room to cut rates, but the upcoming period of interest rate declines will work to the AUD's advantage.

If there is a global recession and significant destabilization of financial markets, it could cause the AUD to soften temporarily. In that case, however, central banks would likely respond by cutting rates, leading to a rebound in risk assets as the economy gradually started to recover, and the AUD/USD would likely rise to a level indicative of their interest rate differential.

Forex Outlook

						Forecasts (vs. outright forward)			
	SPOT	Mar-23	Jun-23	Sep-23	Dec-23	Mar-23	Jun-23	Sep-23	Dec-23
USD/JPY	131.88	130	128	125	123	-0.4%	-0.6%	-1.7%	-2.1%
EUR/USD	1.0730	1.10	1.12	1.14	1.14	2.0%	3.3%	4.7%	4.3%
GBP/USD	1.2184	1.20	1.22	1.24	1.27	-1.7%	-0.2%	1.3%	3.6%
AUD/USD	0.6912	0.70	0.72	0.73	0.75	1.0%	3.5%	4.7%	7.4%
EUR/JPY	141.53	143	143	143	140	1.6%	2.7%	2.9%	2.1%
GBP/JPY	160.69	156	156	155	156	-2.1%	-0.9%	-0.5%	1.5%
AUD/JPY	91.16	91	92	91	92	0.6%	2.9%	2.9%	5.2%

Source: Bloomberg; compiled by Daiwa Securities.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association