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Global Markets Research

Research Alert

FX Outlook: Divergent Recovery

Divergences in the economic outlook will likely shape FX market movements

We now see some reversal in dollar weakness by the end of 2021

We also flag an alternative scenario whereby major geographies get hit by another wave of Covid-19

Key Currency Themes

US dollar weakness persisted in May, continuing the trend which started from April (Figure 1). GBP has caught up after lagging behind in April. In the meantime, Asian currencies have underperformed, in line with our view published on 28 April (Possibilities of More Reversals).

We think that the three main factors affecting FX markets – (1) Covid-19, (2) yield differentials, (3) commodity price movements – will continue shaping trends. The Covid-19 pandemic has, for now, subsided in the US and in Europe/UK. However, a resurgence in Asia will likely still cause some currency underperformance in the affected economies.

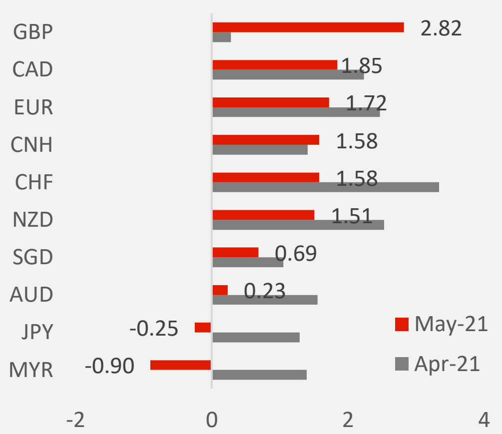
By 2H-2021, FX market movements will likely primarily focus on the US Federal Reserve's monetary policy stance. We revise our forecasts accordingly, anticipating current USD weakness to reverse sometime in the second half of the year. The reversal is likely due to increased market expectations about a reduction in US asset purchases and higher interest rates in the years to come. This is despite our view that the Fed will keep policy rates unchanged in 2021 and 2022.

Our view implies that the DXY bottoms out around 88, and EUR/USD peaks around 1.24. Asian currencies (e.g. MYR) may be relatively more vulnerable (at this point) to shifts in market expectations, as they are likely to lag behind the current global recovery. However, we expect a recovery in Asian currencies later on, catching up with the majors' performances.

Table 1: Revised FX Forecasts

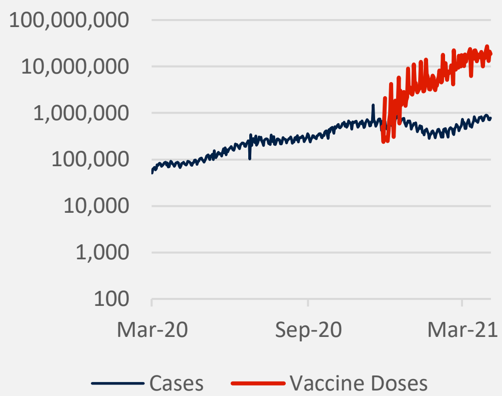
	2Q-21	3Q-21	4Q-21	1Q-22	2Q-22
DXY	89.00	88.00	89.50	90.50	91.50
EUR/USD	1.23	1.24	1.22	1.21	1.20
GBP/USD	1.43	1.44	1.42	1.40	1.38
AUD/USD	0.79	0.80	0.78	0.77	0.76
USD/JPY	108	107.50	109	110	111
USD/MYR	4.13	4.15	4.10	4.10	4.08
USD/SGD	1.32	1.31	1.33	1.33	1.32
USD/CNH	6.35	6.30	6.40	6.50	6.55

Figure 1: FX movements, %



Source: Bloomberg

Figure 2: Net changes in Covid-19 worldwide



Note: Exponential chart. Source: Bloomberg

USD

We review our USD outlook profile over the coming year, pushing DXY forecasts downwards (e.g. 89.00 for 2Q-2021, from 92.50) after prior moves. We now forecast DXY at 89.50 in 4Q-2021 and 91.50 in 2Q-2022.

We expect further dollar weakness (bottoming in 3Q-2021 at 88.00) before a rebound at the tail end of 2021. Yield differentials between the US and other majors continue to rise (Figure 3), partly due to high US inflation rates (4.2% y/y in April, Figure 4).

The divergence is likely to narrow over the course of 2021. A broad-based concern across geographies is that the pickup in producer prices (Figure 5) can be passed to consumers.

Besides, market expectations of US tapering its asset purchases program and hiking its policy rates will likely climb. The US continues to outperform in its economic recovery. In the latest April FOMC meeting, a number of officials have highlighted the need to start discussing about tapering at an upcoming meeting.

EUR & GBP

With the epicentre of the Covid-19 pandemic now in Asia rather than in Europe and United Kingdom, we see some EUR and GBP strength for now. Currency resilience may also originate alongside higher vaccination rates compared to the rest of the world.

We forecast a peak of 1.24 and 1.44 for EUR/USD and GBP/USD respectively, in 3Q-2021. The situation remains relatively fluid, we acknowledge. A reversal in conditions can cause some weaknesses.

May composite PMIs (Eurozone: 56.9, UK: 62.0) show highly expansionary momentum in economic activities. Domestic and travel restrictions have recently been eased, although they pose risks for Covid-19 to spike again.

One area of contention is on central bank stances. The European Central Bank continues to emit dovish signals, while the Bank of England has also described inflation as being "well anchored". If these persists, we anticipate limited upsides to the EUR/USD and GBP/USD, weakening to 1.20 and 1.38 by 2Q-2022.

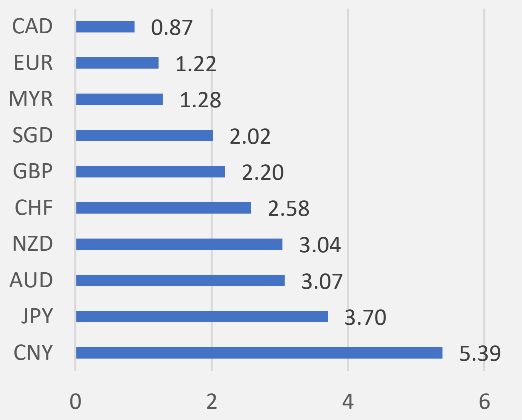
JPY

Comparatively with other G10 currencies, the USD/JPY pair is likely to be more anchored over the coming quarters. The yen is likely to be hit by positive market sentiments, the domestic Covid-19 pandemic outbreak, and subdued inflationary pressures dragging against any Bank of Japan hawkishness (which means that the yield curve control is here to stay). Despite rising PPI, we see subdued inflation from muted wage hikes. This will place the pair mostly under the 107 to 111 range.

CAD may outperform AUD & NZD

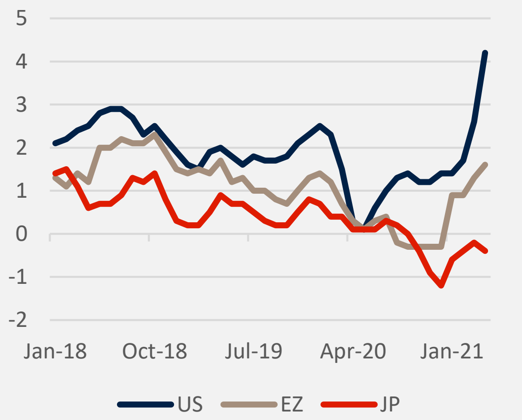
The AUD and NZD have already seen upside support from elevated commodity prices. However, the heightened Covid-19 outbreak situation

Figure 3: Real yield differentials vs the USD (%)



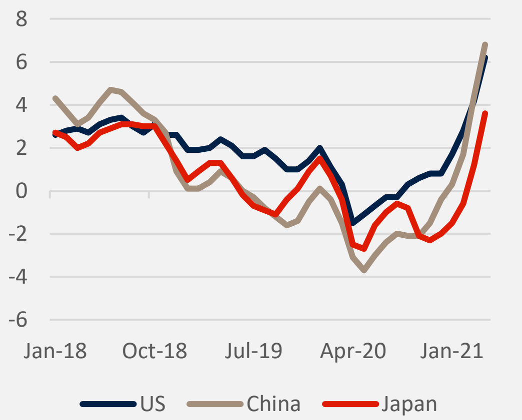
Source: Bloomberg

Figure 4: Headline inflation is rising (% y/y)



Source: Bloomberg

Figure 5: Surging producer input prices (% y/y)



Source: Bloomberg

in Australia and other parts of Asia may dampen on the AUD near-term. We forecast slight upsides for AUD/USD, peaking at 0.80 in 3Q-2021.

With market are expecting the Reserve Bank of New Zealand and the Reserve Bank of Australia among the first few central banks to tighten, we see limited downsides to both the AUD and NZD over a 12-month horizon (forecast of 0.76 by 2Q-2022). The CAD may do better than AUD and NZD over this period (Figure 6), with all the positive factors in play, while Covid-19 cases have steadily declined over the past month.

MYR

The MYR outlook will likely be influenced by USD movements as well as the pandemic development on the local front. In the immediate term, we expect some pressure on MYR amid growth concerns stemming from the nationwide lockdown to contain the elevated infection rates and new virus variants. As a result, we project a slightly higher USD/MYR higher at 4.15 in 3Q21 before pulling back to 4.10 towards end-2021 and 1Q-2022 as the situation stabilizes and vaccination progress picks up. That said, we do see risk to our forecast should growth/policy divergence, and yield differentials with the US widen.

SGD

We shift our USD/SGD forecasts, to bottom out around 1.31 in 3Q-2021 before heading higher to 1.33 in 4Q-2021. The SGD has had a mild blip in May (Figure 7), owing to renewed Covid-19 cases in the island. At the time of writing, the situation has stabilised but remains fluid.

At this stage, vaccination rates are climbing. The government is tweaking its strategy to vaccinate more individuals with one jab, instead of fully vaccinating a smaller group with two jabs.

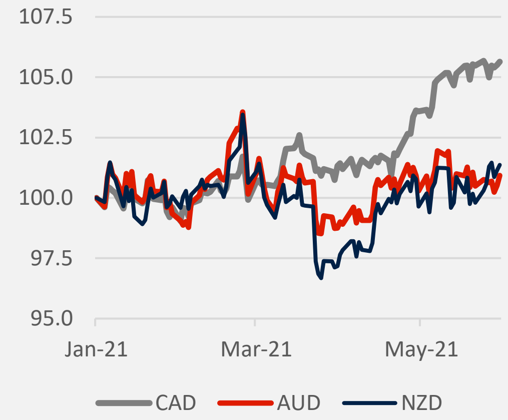
Core inflation has slowly inched up as headline inflation was driven by external (energy prices) and policy factors.

The lingering uncertainty on Covid-19, alongside recovering inflation, supports our view that the Monetary Authority of Singapore may only look to tighten its monetary policy in 2Q-2022. If it happens, the MAS will look to appreciate the SGD Nominal Effective Exchange Rate slightly (we estimate by 0.5% a year), from a zero-appreciation policy since March 2020. We forecast USD/SGD at 1.3200 in 2Q-2022, even though we expect dollar strength in early 2022.

CNY & CNH

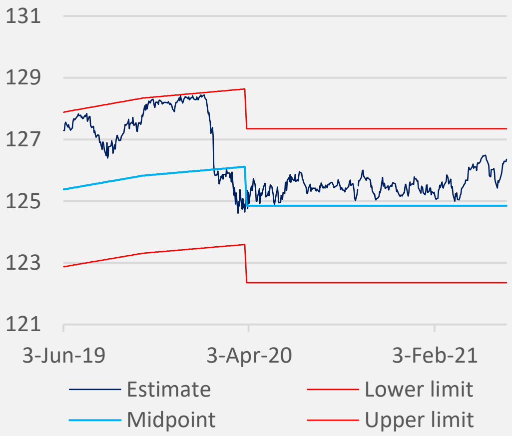
The Chinese yuan has steadily advanced against the USD, better than most Asian currencies but in line with other G10 performances. China's current account surplus is supported by strong export demand for now. USD/CNY is at a three-year low, as the People's Bank of China fixed the USD/CNY daily rate lower in line with USD/CNH movements (Figure 8). However, authorities have signalled on 31 May on the yuan being at overbought territory. We see a near-term low of around 6.34-6.38 near-term. Thereafter, we see a low of 6.30 sometime this year, before a slight rebound to 6.55 by 2Q-2022.

Figure 6: CAD best performing among commodity related currencies (31-Dec=100)



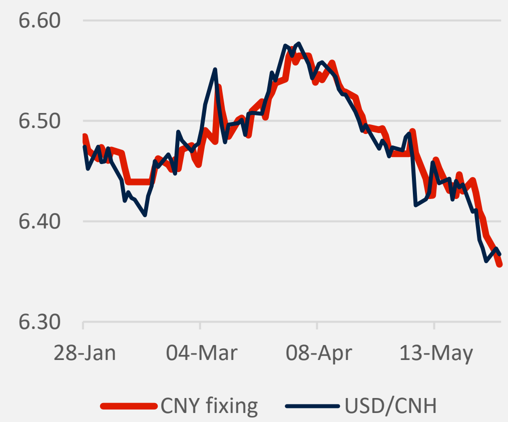
Source: Bloomberg

Figure 7: HL Bank's estimate of the SGD NEER



Source: Bloomberg, HL Bank

Figure 8: Authorities may pull the brakes on further USD/CNH movements



Source: Bloomberg

Fundamentals continue to support the yuan, even as consumer spending did not pick up further from 4Q-2020 levels. We see central bank actions to tackle debt, housing prices and commodity prices. However, the People's Bank of China should keep its rates and the reserve requirement ratio mostly unchanged. Meanwhile, US-China relations can have the potential to make markets move USD/CNY rates higher.

Alternative Scenario: Covid-19 Variant Outbreak in the West

While not occurring at the moment, we flag a risk of another Covid-19 outbreak in the developed markets, possibly from the B.1617 variant of the Covid-19 virus. The implication is a delayed US recovery and its monetary policy tightening cycle, possibly by around 6 months. This is likely to cause some near-term dollar strength and weigh on G10 currencies. The next wave of dollar strength is then likely to come in 1H-2022, after a prolonged dollar weakness in 2H-2021.

Table 2: FX Projections under Scenario

	2Q-21	3Q-21	4Q-21	1Q-22	2Q-22
DXY	91.50	91.00	90.00	90.50	91.50
EUR/USD	1.20	1.21	1.22	1.21	1.20
GBP/USD	1.39	1.40	1.41	1.40	1.38
AUD/USD	0.76	0.77	0.78	0.77	0.76
USD/JPY	108	109	108	109	110
USD/MYR	4.15	4.13	4.10	4.12	4.15
USD/SGD	1.35	1.34	1.32	1.33	1.34
USD/CNH	6.55	6.50	6.45	6.50	6.55

FX Forecasts

FX	3Q-21	4Q-21	1Q-22	2Q-22
DXY	88.00	89.50	90.50	91.50
USD/CAD	1.18	1.20	1.22	1.24
EUR/USD	1.24	1.22	1.21	1.20
GBP/USD	1.44	1.42	1.40	1.38
USD/CHF	0.88	0.89	0.90	0.91
AUD/USD	0.80	0.78	0.77	0.76
NZD/USD	0.74	0.73	0.72	0.71
USD/JPY	107.50	109.00	110.00	111.00
USD/MYR	4.15	4.10	4.10	4.08
USD/SGD	1.31	1.33	1.33	1.32
USD/CNH	6.30	6.40	6.50	6.55

Policy Rate (%)	3Q-21	4Q-21	1Q-22	2Q-22
Fed	0.25-0.50	0.25-0.50	0.25-0.50	0.25-0.50
BOC	0.25	0.25	0.25	0.25
ECB	-0.50	-0.50	-0.50	-0.50
BOE	0.10	0.10	0.10	0.10
SNB	-0.75	-0.75	-0.75	-0.75
RBA	0.10	0.10	0.10	0.10
RBNZ	0.25	0.25	0.25	0.25
BOJ	-0.10	-0.10	-0.10	-0.10
BNM	1.75	1.75	1.75	1.75
MAS	-	Hold	-	Tighten
PBOC	Hold	Hold	Hold	Hold

FX Crosses Forecasts

MYR	3Q-21	4Q-21	1Q-22	2Q-22
EUR/MYR	5.15	5.00	4.96	4.90
GBP/MYR	5.98	5.82	5.74	5.63
AUD/MYR	3.32	3.20	3.16	3.10
SGD/MYR	3.17	3.08	3.08	3.09
MYR/CNH	1.52	1.56	1.59	1.61

SGD	3Q-21	4Q-21	1Q-22	2Q-22
EUR/SGD	1.62	1.62	1.61	1.58
GBP/SGD	1.89	1.89	1.86	1.82
AUD/SGD	1.05	1.04	1.02	1.00
SGD/JPY	82.06	81.95	82.71	84.09
SGD/CNH	4.81	4.81	4.89	4.96

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