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Monthly Forex Market Outlook

August 17, 2023

Overview

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Currency	Current Spot	1M Change	3M Change	6M Change	Next 6M view	Commentary
Dollar Index	103.53	3.70%	0.63%	-0.32%	100-104	10Y UST yields are likely to moderate from current levels as Fed reaches the end of its hiking cycle. We expect dollar gains to be limited on account of narrowing interest rate differentials and loss of its appeal as a safe-haven asset amidst rising global growth optimism.
EUR/USD	1.09	-3.29%	0.24%	1.60%	1.08-1.12	We expect Euro to benefit from favourable interest rate differentials as ECB holds rates higher for longer than Fed. However, any appreciation is likely to be limited as US yields trade at a premium and Eurozone's growth outlook looks bleak.
GBP/USD	1.27	-2.69%	1.87%	5.69%	1.26-1.35	We expect GBP to benefit from favourable interest rate differentials despite concerns over UK's growth as interest rates in the UK remain higher than any other G10 nations.
USD/JPY	146.42	5.54%	6.34%	9.13%	140-148	We expect JPY to benefit from BoJ’s tweak of its yield curve control which signalled the beginning of the end of its ultra-loose monetary policy.
USD/INR	83.10	1.27%	0.84%	0.40%	81-83	We expect INR to benefit from hawkish RBI, robust domestic growth and global risk on sentiment. Healthy forex reserves will enable RBI to curb any volatility that may arise from volatile UST yields, oil prices and weak yuan.

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Major Currencies

Narrowing Interest Rate Differentials to Limit Dollar Gains

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- **Markets have become optimistic about the prospects of a soft US landing as data suggests Fed rate hikes are moderating inflation with little cost to labor market and growth.** Core CPI decelerated for the fourth consecutive month to 4.7% YoY in July. Unemployment rate stood at 3.5% in July i.e. lower than the 3.8% before Fed started rate hikes. Q2 GDP growth exceeded expectations and Fed staff relaxed its projections of a recession this year.

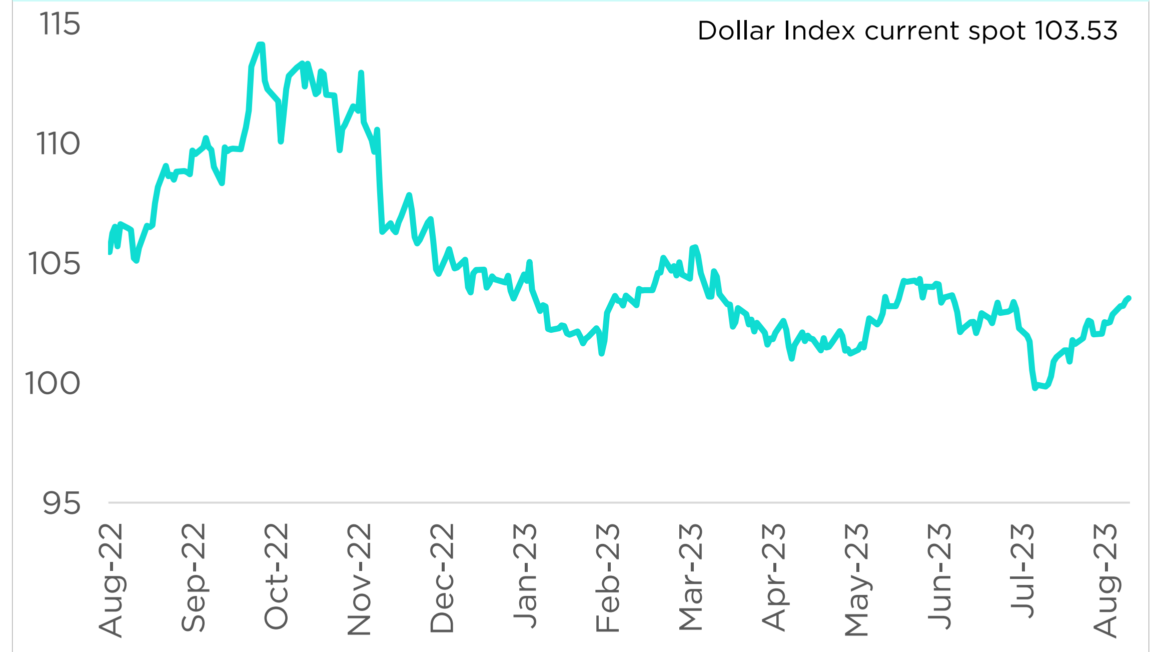
- Fitch's unexpected downgrade of US sovereign credit rating did not have material impact in the absence of more liquid alternatives to the dollar.

- **Treasury yields have surged due to a confluence of factors including Treasury Department's announcement of higher net borrowings, Moody's rating downgrade of US banks and resilient economic data**. Benchmark 10Y UST yield rose ~50bps over the last month and is currently trading at 4.30% - the highest level since 2008. However, yields are expected to moderate from current levels as Fed reaches the end of its hiking cycle.

- Fed delivered a 25bps hike in July after a pause in June. Market pricing suggests **Fed is not likely to hike rates any further**. **It is expected to cut rates aggressively in 2024** – by 100bps starting June.

- Going ahead, **dollar gains are likely to be limited on account of narrowing interest rate differentials.** Further, **global growth optimism** is likely **to temper dollar's appeal** as a safe-haven asset. However, **upside risks may arise if inflationary pressures resurge and/or geopolitical risks emerge.**

Dollar reversed losses and strengthened 3.70% over the last month on prospects of a soft US landing and surge in Treasury yields



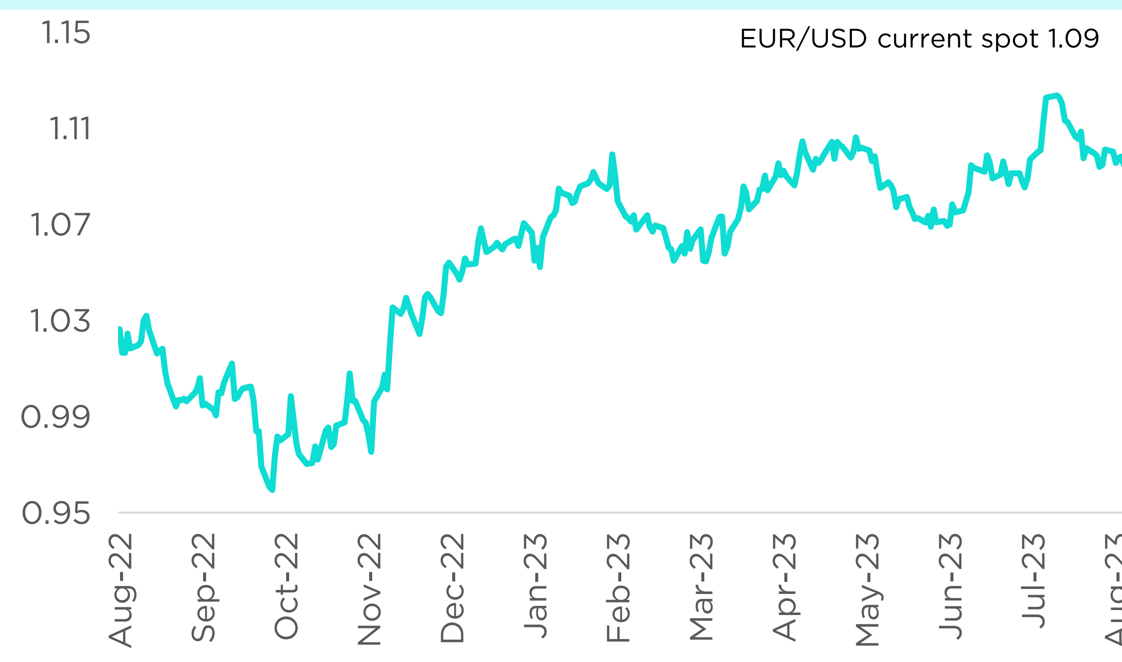
Source: Refinitiv

Dollar index likely to trade between 100-104 in the near term

Rising Growth Concerns to Limit Euro's Appreciation

- **Eurozone's core inflation remains sticky**. It rose 5.5% YoY in July – unchanged from June and close to the record high of 5.7% in March.
- Hot labour market (unemployment rate stands at a record low of 6.3%) is contributing to wage-price spiral. This in turn is fuelling the cost of services.
- Large drop in real incomes and rate hikes is starting to impact economic growth. The Eurozone economy grew by 0.6% YoY in **Q2 2023 - the weakest pace of growth since the 2020-21 recession**.
- ECB raised interest rates for the ninth consecutive time in July. ECB's policy statement indicates it may be near the end of tightening.
- Market pricing suggests **ECB is not likely to hike rates any further** as recession worries mount. However**, it is also not expected to cut rates any time soon as sticky core inflation remains a concern**.
- Going ahead, **Euro is likely to benefit from favourable interest rate differentials** as ECB holds rates higher for longer than Fed. However, **any appreciation is likely to be limited as US yields will continue to trade at a premium** (currently 10Y UST yield is trading 160bps above 10Y bund) **and Eurozone's growth outlook looks bleak.**

Euro weakened 3.29% over the last month amidst growth concerns and as ECB policy statement indicated it was close to end of tightening



Source: Refinitiv

EUR/USD likely to trade between 1.08-1.12 in the near term

Higher Interest Rates Likely to Support British Pound

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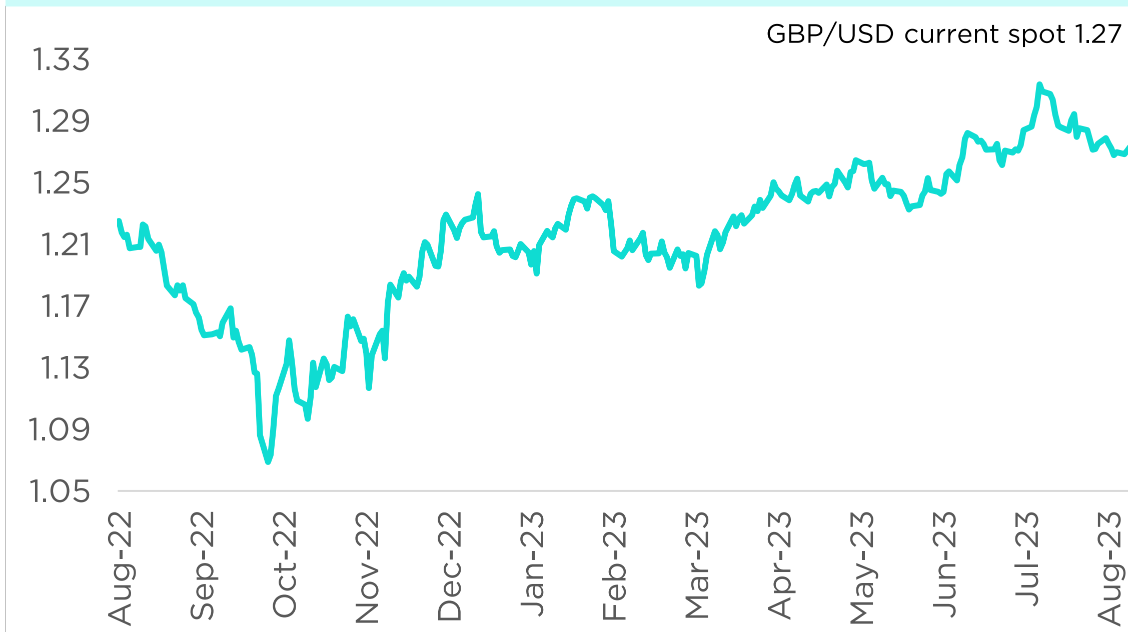
- **UK's headline inflation** has moderated from a 41 year high of 11.1% YoY in October 2022 to 6.8%. However, it **is the highest in any major economy**. Core inflation at 6.9% also remains well above BoE's 2% inflation target. Wage rises have been a big driver of inflation. **BoE does not expect inflation to return to its 2% target until Q2 2025** i.e. three months later than its previous forecast.
- Unlike the US and Eurozone, unemployment rate in UK has risen. It stands at 4.2% - the highest level since Q4 2021.
- Though UK's economy defied expectations of stagnation **in Q2 2023, it grew by a meagre 0.2% YoY**. Further, BoE expects UK to expand by 0.5% in 2023 and 2024 and just 0.25% in 2025.
- BoE hiked interest rates for the 14th consecutive time in August. It described its policy stance as "restrictive" for the first time. Consequently, investors moved to price in slightly less BoE tightening.
- Still, market pricing suggests **BoE will hike rates by 25bps each in the next two meetings before pausing. It is expected to cut rates in 2024 albeit by a much smaller quantum than Fed.**
- **Interest rates in UK are expected to stay higher than any other G10 nations**. Going ahead, **GBP is likely to benefit from favourable interest rate differentials despite concerns over UK's growth.**

British Pound weakened 2.69% over the last month amidst strong dollar and as markets priced in slightly less BoE tightening



Source: Refinitiv

GBP/USD likely to trade between 1.26-1.35 in the near term

Japanese Yen Expected to Benefit from Tweak in Yield Curve Control

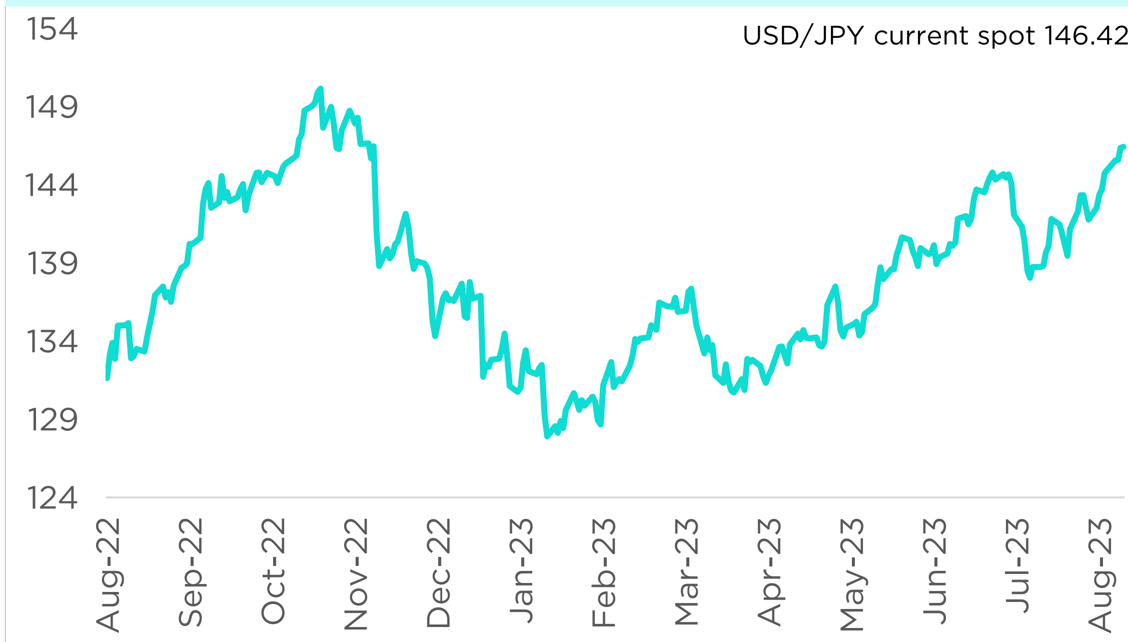
- **Core inflation edged higher** to 3.3% YoY in June from 3.2% May – as firms passed on higher import costs to households. Inflation has been outside BoJ's 2% target for the 15th consecutive month. **BoJ revised up its core inflation forecast for 2023 to 2.5% from 1.8% earlier**. The move was driven partly by a notable upshoot in inflation expectations as more firms hiked prices and wages. **However, its price forecasts for 2024 (1.9%) and 2025 (1.6%) were unchanged.**

- Japan's **Q2 GDP** grew at 6% on an annualised basis **beating market expectations** of 3.1%. Robust auto exports and tourist arrivals offered support.

- In July **BoJ said it needs to maintain ultra-low rates** until demand pull factors replace cost push factors as key drivers of inflation and keep inflation sustainably around its target. **However, it surprised markets by announcing a change to its yield curve control policy** - BoJ raised the cap on its 10Y government bond yields from 0.5% to 1%. Markets are speculating that this might be the beginning of the end of Japan's three decades of ultra loose policy.

- Going ahead, **JPY may benefit from favourable interest rate differentials** as UST yields moderate and Japanese yields rise following BoJ's tweak of its yield curve control policy.

Japanese Yen weakened 5.54% over the last month and touched a nine-month low amidst surge in UST yields and no intervention by BoJ/MoF



Source: Refinitiv

USD/JPY likely to trade between 140-148 in the near term

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Indian Rupee

Rupee Hits All Time Low Against the Dollar

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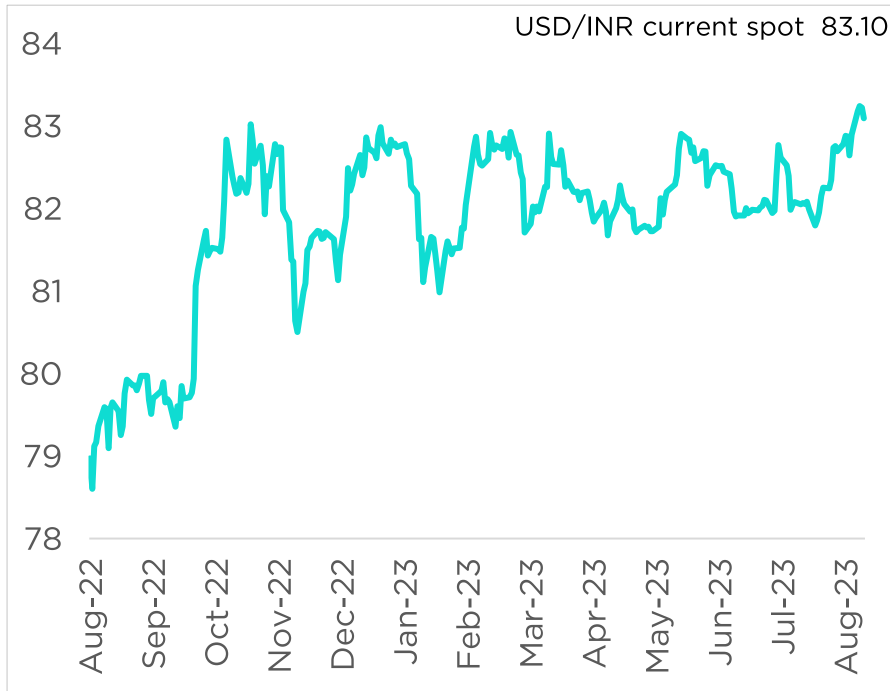
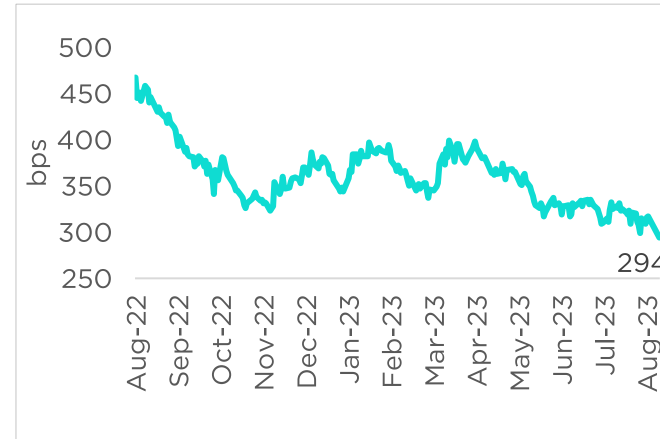
Over the month rupee depreciated by 1.27% against the dollar and traded b/w 81.80-83.24



Source: Refinitiv

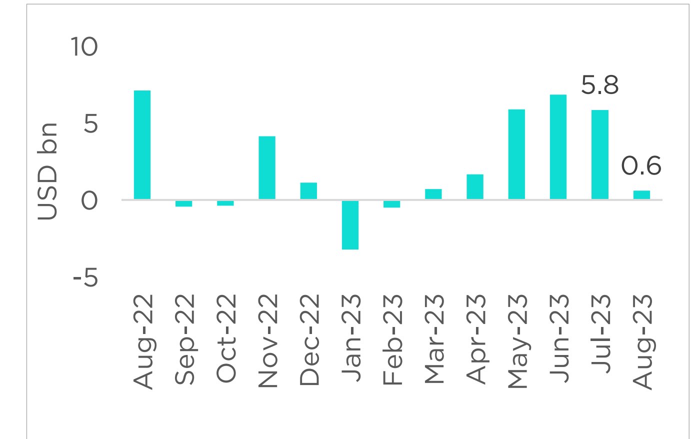
Narrowing interest rate differentials and rising oil prices weighed on rupee. FPIs continued to record net inflows albeit at a slower pace amidst rising UST yields. RBI interventions limited volatility.

10Y USD-INR interest rate differentials narrowed



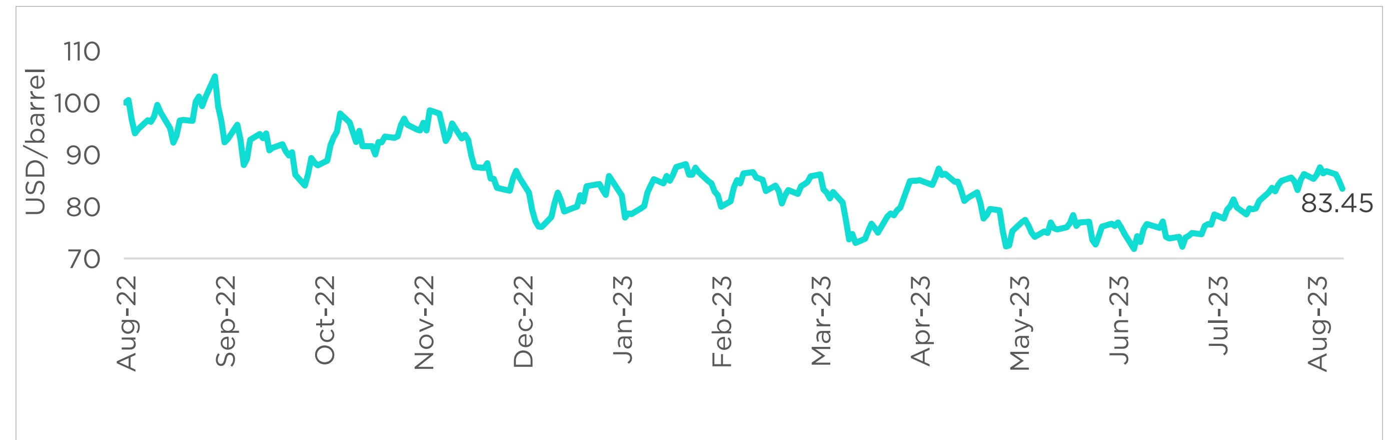
Source: Refinitiv

FPIs recorded net inflows – albeit at slower pace



Source: CEIC. Note – Data as on August 16,2023.

Brent oil prices rose 6% MoM as tight supply worries outweighed demand concerns



Source: Refinitiv

Rupee Appreciates for Second Consecutive Month as per REER

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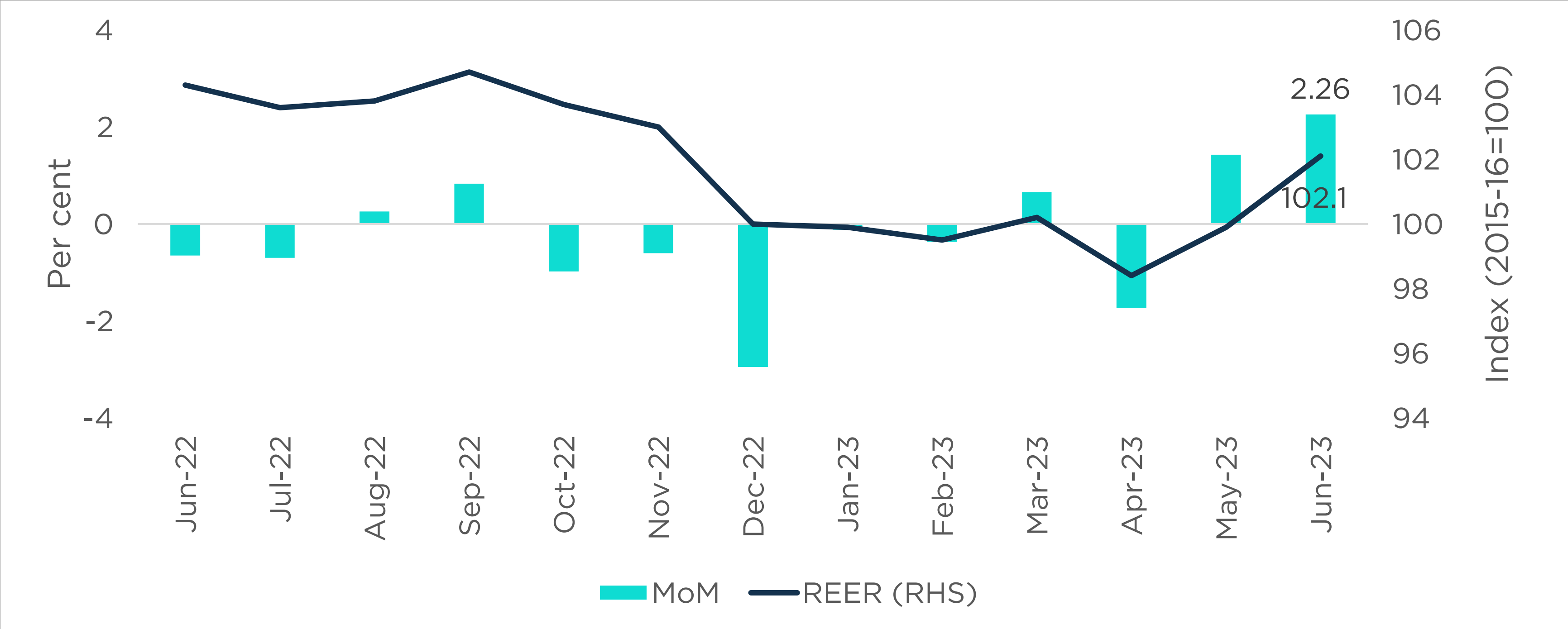

Source: CMIE

Note: MoM stands for month-on-month.

Rupee appreciated 2.3% MoM in June 2023 as per REER - implying a loss in trade competitiveness as exports became more expensive and imports became cheaper.

Rupee Exhibits Least Volatility vs Peers

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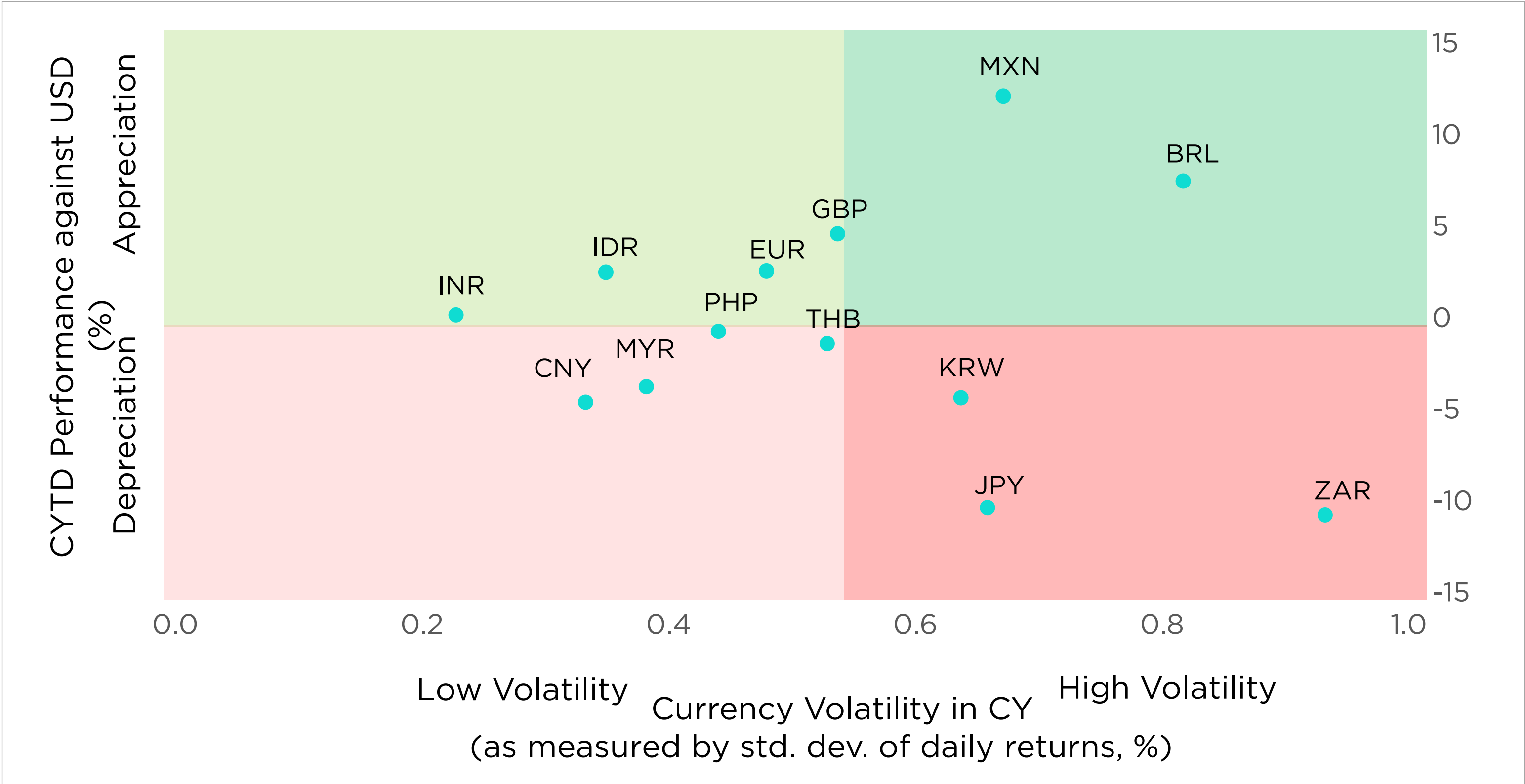
INR vs Peers - Comparative Performance in 2023



Source: CareEdge; Refinitiv

Note: Data as on August 10, 2023.

RBI interventions curbed rupee's volatility.
Rupee has been less volatile than developed market currencies (eg. EUR, GBP, JPY) in 2023.

Rupee Likely to Trade b/w 81-83 in the Near Term with Appreciation Bias

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RBI's hawkish policy response to rising inflationary pressures is expected to support the rupee (retail inflation surged to 7.4% YoY in July from 4.9% in June and was well above market expectations of 6.4% - primarily due to higher vegetable prices. However, core inflation moderated to 5.1% in July from 5.3%). **The market is no longer pricing in rate cuts in the current fiscal.**

FPI net inflows are likely to sustain as domestic economy remains resilient (at its August policy, RBI retained its FY24 growth forecast at 6.5% despite revising its inflation forecast upwards by 30bps). Further, rupee is expected to benefit from risk on sentiment amidst global growth optimism.

India's external front remains favorable (balance of payment surplus improved significantly from USD 5.6bn in Q4FY23 to USD 24.4bn in Q1 FY24). Current account deficit is expected to narrow in FY24 on account of shrinking trade deficit and robust services exports.

Ample forex reserves (recently crossed the USD 600 billion mark) will enable RBI **to curb any volatility that may arise from volatile UST yields, oil prices and weak yuan** (on account of faltering recovery in China).

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