Mizuho Chart Speak: USD & AXJ

Economics & Strategy | Asia ex-Japan

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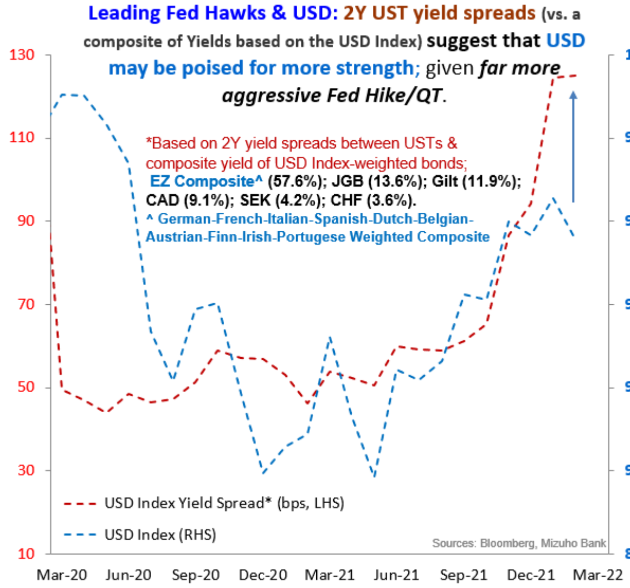
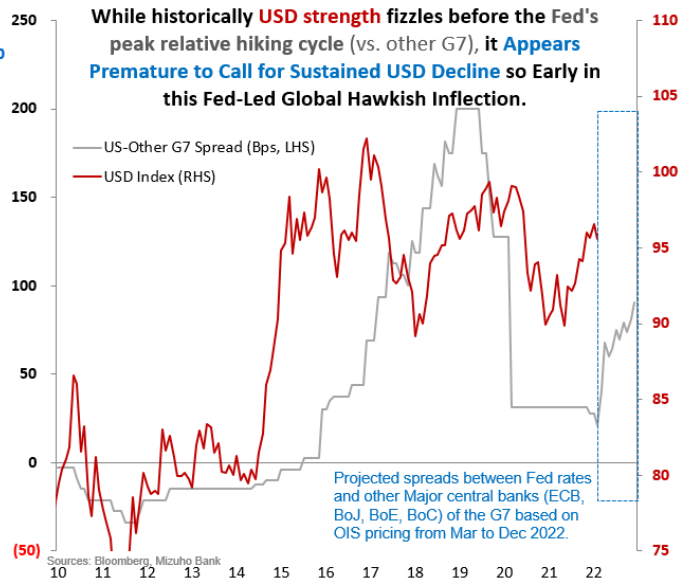
Why ECB Hawks May Merely Temper, Not Necessarily Terminate USD Bulls

In a Nutshell: Whether the **ECB's unexpectedly early hawkish pivot** has **temporarily dissociated or durably dislodged Greenback ascendancy** derived from an increasingly hawkish Fed is the **elephant in the room**. Specifically, inferences of *strong USD as a consequence of hawkish Fed divergence* (vs. ECB) appear to be *at risk of being upended as the narrative is rudely flipped to "convergence".* The jury is out and volatility, in the meantime, is up.

But ***regardless,*** **opportunistic EM Asia FX (AXJ) strength exploiting aspersions cast on USD bulls is not our base case**. For one, the **Fed is likely to maintain its relative hawkish edge** on global policy inflection. In turn rendering *backstop, if not buoyancy, for the USD.* Second, **impending reversal of US inflation overshoot vis-à-vis EM Asia** could *sharpen (PPP-based) USD strength* (vs. AXJ); **as US real rate catches up**. Third, **rising** (nominal and real) **rates in US and Euro-zone curtail** AXJ boost from **capital inflows as well as USD- and EUR-funded "carry trades"**. Notably, **higher volatility** amid sharper policy shifts **will deter, if not kill "carry"**.

Fourth, **elevated, if not escalating, oil** is **inclined to undermine AXJ via Current Account, fiscal and inflationary pressures**. Fifth, **rising geo-political risks**, tend to **dampen EM Asia FX** *amid additional safe-haven demand for USD.* Finally, **Beijing's "stable" guidance for a rich CNY NEER** entails ***asymmetric bias to dampen appreciation against broad USD weakness***; indirectly **deterring opportunistic, sharp AXJ gains on episodes of USD pullback**. All said, while the ECB's hawkish flex may **deprive USD bulls of a more prolonged "policy divergence" boost**, it does not categorically **bury the Greenback in unrelenting bearish waves**. Especially not against AXJ, which are further checked by, shifting real rates, volatility elevated oil, geo-political risks and CNY dampener.





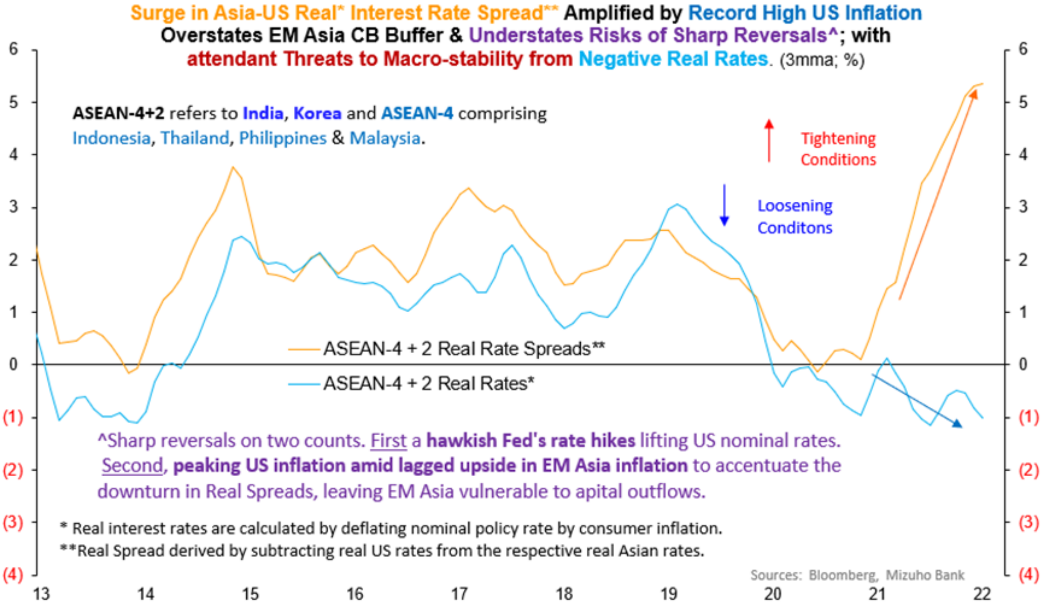
ECB Startling USD Bulls: As understatements go, the **ECB's abrupt and early hawkish turn*** **has startled**, **possibly catching USD bulls** *banking on Fed-ECB policy divergence* **wrong-footed**. The **ECB's sudden "curve chasing"** (to mitigate behind-the-curve risks) arguably **flips the FX market narrative from Fed-ECB divergence to convergence**. And at the margin, this means that **bullish USD bets predicated on sustained policy divergence** (at least through H1 2022) will be **forced to re-assess; *possibly re-price*** FX outcomes.

Volatility, Not Vulnerability: And so, unsurprisingly, USD bulls are likely to have been disrupted; certainly, denied unfettered passage. *But* equally, it is **premature to declare that this is an enduring USD erosion**. What results is **higher volatility amid a lack of clarity**, but *not necessarily USD vulnerability.*

1. Fed's Relative Hawkish Edge: A key reason not to forsake the narrative of the USD retaining an edge, at least in H1 2022, is that the **Fed**, *relative to the ECB,* is **poised to persist with its hawkish edge**. Point being, the **Fed**, with higher and more broad-based inflation alongside solid jobs recovery is **more likely to unwaveringly to walk the hawkish talk** through mid-/Q3-2022. *In contrast,* the ECB's inflation concerns are somewhat more skewed and not as evenly matched by growth and/or jobs out-run. Alongside a wider dispersion of views within the ECB, this sets the stage for the ECB's more guarded hawkish impulses to falter.

Supports USD & Dampens AXJ Upside: Correspondingly, this may **merely temper and interrupt**, not traumatize and incapacitate, **USD bulls** into H1 2022. And so, hasty conclusions about USD decline may be misguided. In particular, expectations of sustained USD pullback vis-à-vis EM Asia FX (AXJ). Point being, **one-dimensional bets on AXJ bulls seizing (Fed-ECB) hawkish "convergence" misses the forest for the trees**.

2. Real Rates & Fading Inflation Blips: Afterall, it is important to recognise that the **current allure of AXJ** is **flattered by *exceptional inversion of US-EM Asia inflation differentials***. Specifically, inflation in US significantly outpacing that in EM Asia **accentuates the excess real returns/yields in EM Asia**; thereby boosting AXJ. But *US inflation overshoot vis-à-vis EM Asia is a blip that is set to fade* (in coming months), if not reverse. And as a corollary, this means that a **rebound in real US rates/yields will bear down on EM Asia assets** (and **FX**) *as EM Asia-US real rate differentials turn sharply less attractive*.



3. "Carry" Curtailment & Capital Deterrent: Moreover, **rising real US rates** *that raise the hurdle for capital inflows into EM Asia* are typically **far less desirable for EM Asia assets and AXJ**. A **fast money iteration** of which, is **sharply diminished desirability of "carry" trades**. Specifically, **more hawkish Fed and ECB** policies lifting rates on either side of the Atlantic means that **both USD- and EUR-funded "carry" trades are** less compelling, perhaps **appreciably curtailed**. Consequently, indirect AXJ boost from Fed-ECB convergence setting back USD strength is checked, if not eliminated, by declines in "carry" trade interest. **Especially if volatility**, *a brutal deterrent of "carry",* **is amplified by the conspiracy of global liquidity drainage and geo-political risks**.

4. Crude/Commodities: What's more, **surging crude** (and wider commodity) prices **impede the ability of AXJ to capitalize on broader USD declines** insofar that "twin deficits" risks are amplified by the simultaneous deterioration in the Current Account and fiscal positions. In addition, **oil's inflationary impact could hasten** the catch-up of EM Asia's inflation, accentuating the **impending erosion in real rate differentials that are currently supportive of AXJ**.

5. Geopolitical USD Premium: Furthermore, USD is expected to be **underpinned by safe-haven demand, especially vs. EM currencies** (including AXJ), amid **rising geo-political tensions** and the **implied risks**. Admittedly, this may *not always easy to consistently or precisely price* (given uncertainties around incidence and timing). But all else equal, growing geo-political risks render one-way bets against USD riskier.

6. CNY Dampener: Finally, **Beijing's guidance for a "basically stable" CNY policy**, **entails** a particular ***asymmetric bias for diminished appreciation***. Apart from dampened CNY volatility, post-2015 highs in CNY NEER means that

at the margin, the **PBoC may hamper CNY appreciation** (*vs. falling USD*) **to a greater degree than it resists CNY weakening** (*vs. rising USD*). In turn, this nuanced, but **noticeable CNY appreciation dampener will**, to some extent, **indirectly deter sharp, opportunistic AXJ gains against broad-based USD pullback**.

USD-AXJ Upshot: All said, as **pivotal as the ECB's hawkish turn is**, it **may not be as overwhelmingly profound** as may be otherwise assumed. So, **USD bulls** *counting on tailwinds from an increasingly hawkish Fed,* whilst **deprived of a more prolonged "policy divergence" boost**, are **not relegated to be buried in unrelenting bearish waves** either. Especially not against AXJ, which are likely to be rein in by a conspiracy of; i) US Fed hawks retaining an edge; ii) shifting inflation and real differentials; iii) resultant curtailment of capital inflows as well as "carry"; iv) inconveniently elevated oil/commodities; v), geo-political risks and; vi) CNY dampener. As a result of which, we have only tempered USD strength against AXJ (whilst imputing greater volatility) for H1 2022 in our revised forecasts below.

FX Forecasts	Mar 22	Jun 22	Sep 22	Dec 22	Mar 23	Jun 23
USD/CNY	6.17 - 6.49 (6.43)	6.34 - 6.64 (6.45)	6.19 - 6.67 (6.34)	6.13 - 6.58 (6.33)	6.18 - 6.64 (6.38)	6.14 - 6.50 (6.34)
USD/INR	73.2 - 77.3 (76.5)	74.0 - 78.5 (76.0)	72.0 - 77.0 (74.8)	70.4 - 76.6 (74.2)	69.2 - 75.4 (73.0)	69.7 - 76.0 (73.5)
USD/KRW	1160 - 1230 (1220)	1150 - 1270 (1200)	1140 - 1240 (1180)	1100 - 1200 (1150)	1080 - 1180 (1120)	1070 - 1160 (1114)
USD/SGD	1.32 - 1.37 (1.36)	1.31 - 1.38 (1.35)	1.30 - 1.40 (1.34)	1.29 - 1.37 (1.32)	1.29 - 1.37 (1.33)	1.30 - 1.37 (1.33)
USD/IDR	14210 - 14900 (14600)	14400 - 15150 (14750)	13970 - 15250 (14400)	13790 - 14980 (14250)	13650 - 14830 (14100)	13600 - 14900 (14050)
USD/MYR	3.98 - 4.25 (4.23)	4.16 - 4.43 (4.21)	3.93 - 4.32 (4.18)	3.97 - 4.30 (4.16)	4.00 - 4.32 (4.17)	3.97 - 4.30 (4.14)
USD/PHP	50.4 - 52.6 (52.2)	51.2 - 53.5 (51.8)	48.8 - 52.4 (50.9)	47.8 - 51.5 (50.0)	48.0 - 51.6 (50.1)	47.1 - 51.1 (49.2)
USD/THB	32.2 - 34.0 (33.6)	33.2 - 35.8 (33.8)	31.2 - 34.2 (33.0)	30.2 - 33.1 (32.0)	30.7 - 32.9 (31.6)	30.1 - 32.2 (31.0)
USD/VND	22500 - 23200 (23100)	22800 - 23400 (23100)	22500 - 23200 (22800)	22500 - 23100 (22600)	22500 - 23000 (22650)	22300 - 22900 (22550)
AUD/USD	0.666 - 0.734 (0.703)	0.682 - 0.773 (0.715)	0.681 - 0.768 (0.735)	0.726 - 0.808 (0.765)	0.749 - 0.825 (0.788)	0.749 - 0.819 (0.780)

* The ECB unexpectedly conceding rate hike in 2022, whereas even APP taper (meant to precede rate hikes) guidance went well into 2023 earlier indications. Admittedly, this is still a long way off the Fed's hawkish amplitude; with 125bps of rate hikes for 2022 starting with March lift-off as well as balance sheet run-off within (albeit later in) 2022. But the "hawkish" surprise much sooner impresses with the switch flip to convergence (from divergence) rather than absolutes in terms of degree of tightening.