# **G3 FX OUTLOOK:** INTEREST RATE DIFFERENTIALS RETURN TO THE FORE

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Risks for 2022 were clearly highlighted around year-end 2021, as inflation expectations and monetary policy tightening cycles were almost eclipsed by the emergence of the Omicron variant and the subsequent implementation of some movement restrictions in parts of Europe. Until there is a global approach to managing the virus, vaccine distribution improves, or the virulence of the pandemic subsides, there is likely to be a shadow lurking over the global recovery, and risk-asset markets could be susceptible to sharp repricing.

However, from a baseline perspective, with the Federal Reserve increasingly convinced of the threat of more enduring inflation and continuing supply-side issues, government bond curves have priced hike expectations, helping the dollar build some momentum into year end. There is still room for a steeper front end for US dollar assets, while other developed markets have potentially overshot in terms of pricing rate hikes. The developed economies of the G7 are also eclipsed by the aggressive steps already being taken by some emerging markets.

For the British pound (GBP) in particular, the aggressive nature of rate hikes priced into the front-end contrasts starkly with the more conservative dollar curve; gilt futures were recently pricing in 3.5 hikes this year, compared to fewer than three for dollar bonds. With multiple FOMC members embracing a faster end to tapering and a cautiously hawkish approach to monetary policy the dollar curve looks mispriced, and any adjustment higher would give further support to the US dollar on its index.

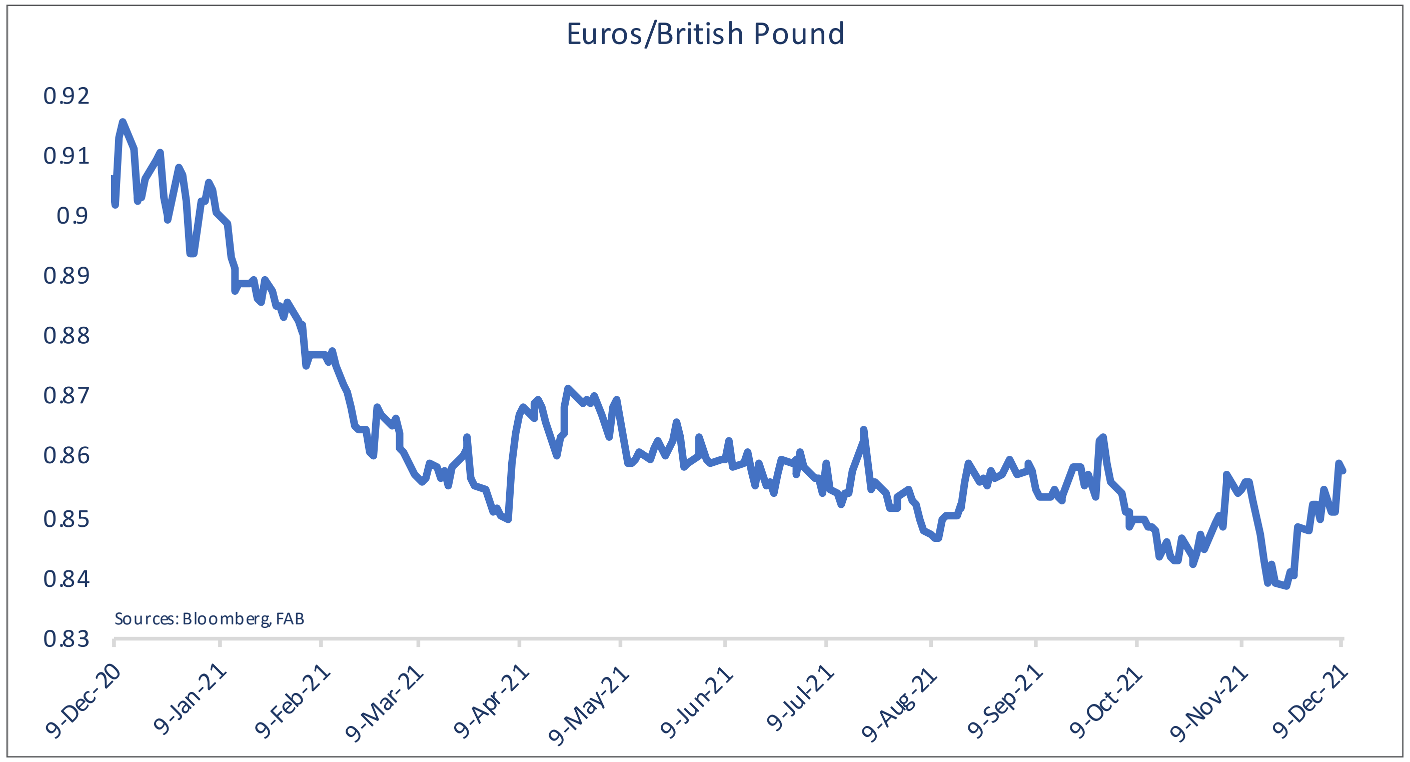
Conversely, the UK rate path has little room for upside from here, and it faces several pressures that could eclipse the economic recovery in the first half of the year. The Brexit fallout continues to rumble on with the Northern Irish border a very sensitive issue, and Northern Ireland Assembly elections in May could cause some further angst and volatility in markets already susceptible to this topic. The increasing pressure to resign on Boris Johnson is unlikely to yield such a result, but the barrage of headlines attacking the incumbent UK government 'sleaze' have weakened his government's position and are also weighing on the pound.

That said, the fundamentals are solid for the UK economy and, barring further COVID shocks, there could be support for the British pound, but it is difficult to see a push much above US$1.35/GBP in the first half of this year. There is even the possibility of a dip back towards US$1.28/GBP, although those levels may instigate buyers.

European bond futures are still lagging in terms of pricing any central bank hikes and are likely to remain passive for most of this year, despite inflationary pressures. Chairwoman Christine Lagarde has a tough job ahead to keep the ECB's rate-setting committee united around the easy policy that has now been in place for well over a decade.

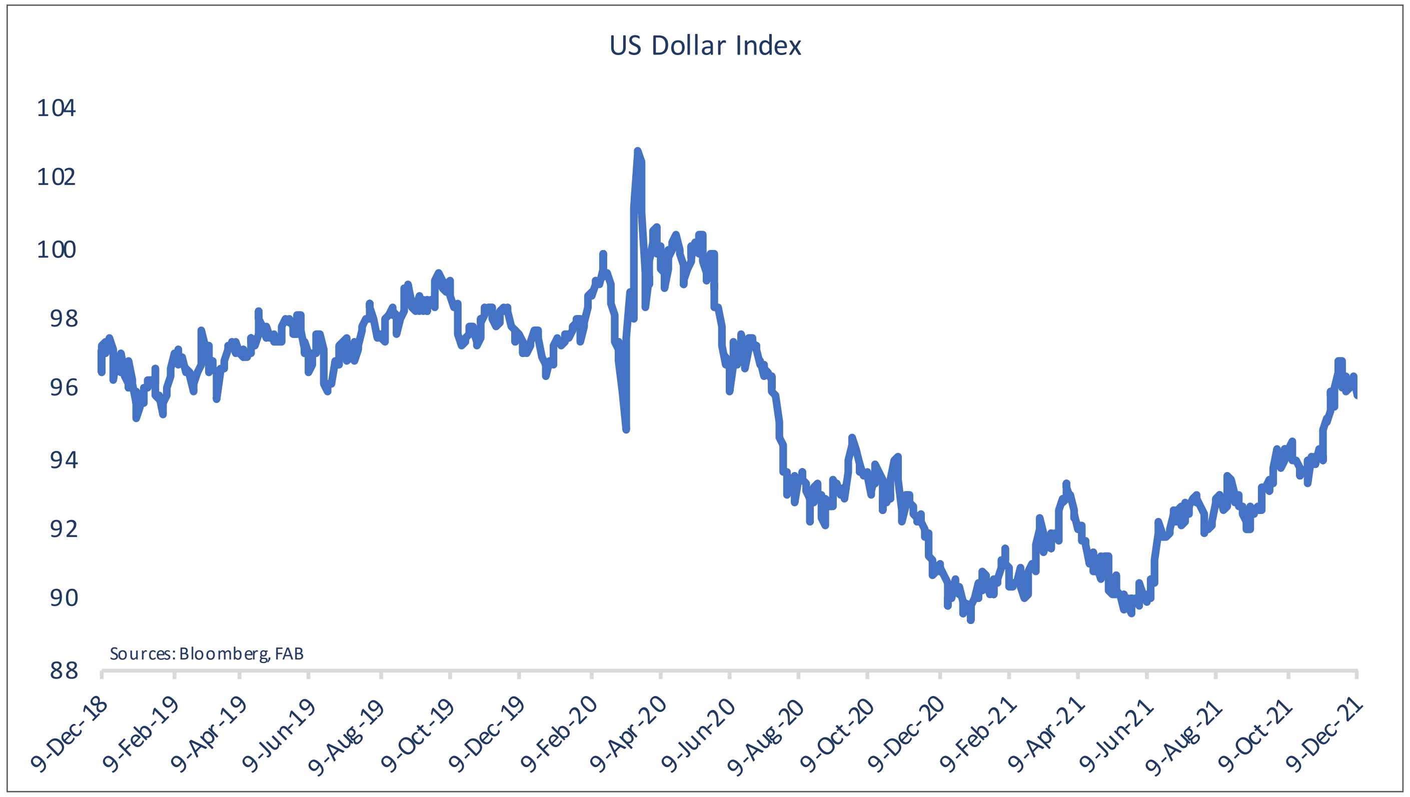
This laissez-faire approach from ECB members is in stark contrast to the rest of the G7 central banks (with the exception of the Bank of Japan), with markets pricing a hike of only 10 basis points in 2022. Negative rates are priced in, even past the four-year forward point. At best, the ECB will end its asset purchase programme in March and the monthly purchases will sit at around EUR 20 billion.

The single currency failed to break the US$1.12/EUR support level on the initial Omicron lockdowns, but since then it has struggled to move away from the US$1.1300-US$1.1350/EUR zone. Potentially continued dollar strength in the first quarter could exert further pressure on the euro, although positive Omicron news would be supportive, in the short-term at least, and a move towards US$1.15/EUR appears possible by March 2022, with an increase in volatility set to stay.




The euro was relatively range-bound in relation to the British pound in the second half of 2021, and is likely to continue in this manner in the first half of this year. The drivers are clear from the perspectives of interest rates and economic growth. Based on historical data, the euro should weaken against the British pound on the advent of any new variant of the virus with good entry levels above EUR 0.86/GBP, and with the possibility to take profits towards EUR 0.845/GBP.

The US Dollar Index has also benefitted from the weaker virus management and aggressive lockdowns seen in Europe with a 2% gain between the start of November and mid-December of 2021, when it was hovering around 96.00. For the first half, there is still potential for upside, although 100.00 would likely be a strong resistance level. However, a gradual move towards these levels during the first quarter is certainly on the cards, given the possibility for an increased pace of hikes from the Fed to rebalance across the basket of currencies that form the US Dollar Index.





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