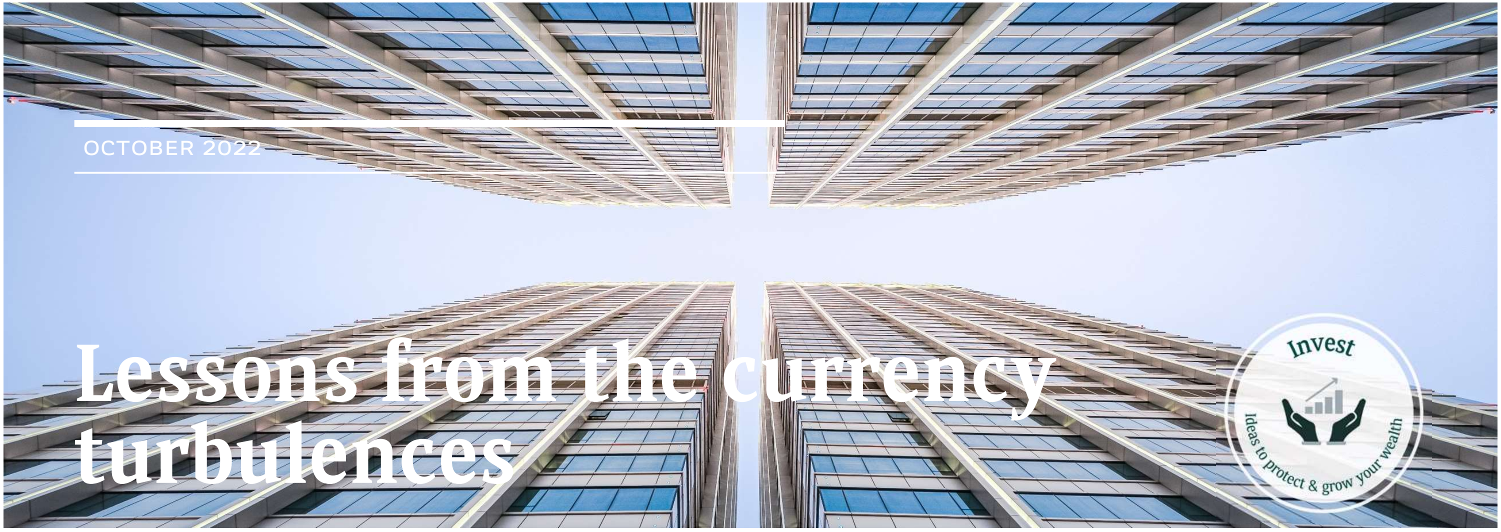


OCTOBER 2022

Lessons from the currency turbulences

Summary

The dollar continued to move higher in a context of rising expectations for the Fed terminal rate and global risk aversion. The DXY index increased by around 5% over September and by around 20% since the beginning of the year.

Faced with the decline of their currencies, some central banks had to intervene like the Bank of Japan which defended the yen by selling the dollar or the Bank of England which bought long-term debt.

Market expectations are quite high for the Fed and we think that this is exaggerated. For the EURUSD, we now target parity over 3-month due to sustained uncertainty in the short-term. We have a 12-month target of 1.08.

In the UK, the Prime Minister's new plan is making markets nervous as it generates new uncertainties and fears regarding debt sustainability. We lower our targets for the EURGBP and we now forecast 0.90 both at 3 and 12 months.

The Bank of Japan still did not raise its target rate. There could be more downside for the currency in the short-term. We are lowering our targets on the YEN.

The AUD and NZD are affected by recession fears and the Chinese slowdown. The CNY is also under pressure from the US rate hikes. We are changing our targets on these 3 currencies.

Risk aversion as a key driver

The global uncertainty remains at a multi-year high. The reasons are obvious. The conflict in the Ukraine has led to an energy crisis and the fear of a broader geopolitical crisis. Supply chain disruptions and high energy prices have led to very high inflation rates of the type not seen for several decades. Central banks have been obliged to reverse longstanding low interest rate policies. Nearly all major central banks (except China and Japan) have embarked on a series of rate hikes, to curb demand and bring down inflation. This environment has been beneficial for safe heaven currencies like the dollar and the Swiss franc. The dollar index which is a weighted average of six currencies has been recording major gains this year. Currencies of countries with a high dependency to Chinese growth like the AUD and NZD have suffered somewhat more compared to others (CAD). The euro is down sharply against the dollar but much less against other currencies.

The risk aversion has led several currencies to trade much weaker than suggested by fundamental drivers such as the interest rate differential and the purchasing power parity. We are looking for a gradual improvement in uncertainty due to a trend change in inflation, a gradual fall in uncertainty regarding energy prices and more visibility regarding Chinese growth. Let's have a closer look.

Guy Ertz, PhD

Chief Investment Advisor,
BNP Paribas Wealth Management

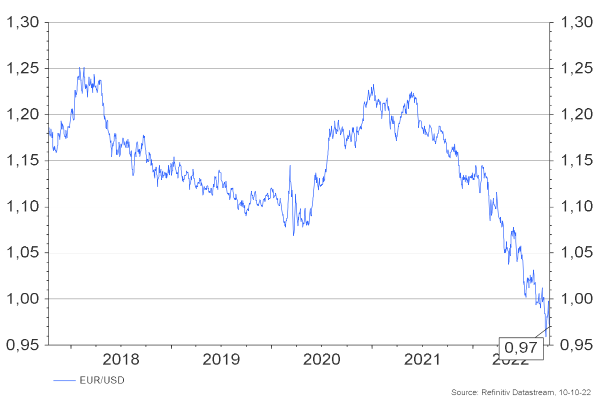
Dollar overvalued against the euro

For the Fed, we now expect a terminal rate of 4.5% to be reached by the end of the year. The market expectations suggest an even higher rate but that seems exaggerated. For the ECB, we expect a terminal rate of 2.75% and the ECB will speed up the processes in the coming months. The interest rate differential as measured by the difference between the 2-year yields, should gradually move more in favor of the euro. In the medium-term, the key driver will remain the Purchasing Power Parity (PPP). It measures the exchange rate that equalizes the price of a representative basket of goods when calculated in dollars. The estimated long-term fair value for one euro ("Purchasing Power Parity" or PPP) provided by the OECD is around 1.37 dollars (based on Germany's figures). Deviations from PPP can be seen over a long period. Some academic studies suggest that a more relevant approach would be the so-called notion of half-life. Following Craig (2005) "a half-life represents the amount of time that elapses before a discrepancy between the PPP level and the current exchange rate is half its current size". He found that for large differences that period could be around 12 to 18 months. Currently, the notion of half-life would be the time needed to move back to around 1.20. **We maintain our 12-month target at 1.08 (value of one euro). Short-term, the euro should move closer to parity.**

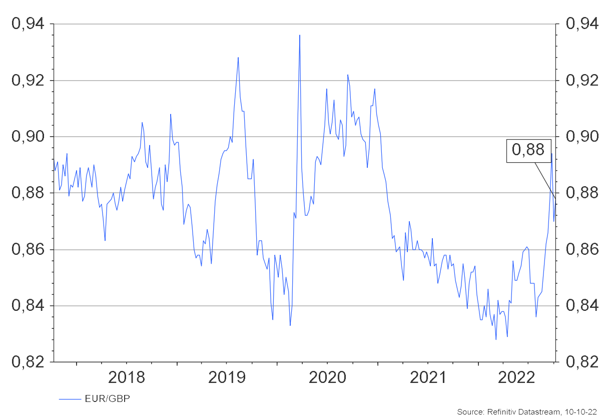
The Sterling under massive pressure

The UK is facing key challenges and the currency (GBP) lost almost 5% against the EUR in September. The new Prime Minister has presented a budget plan to address the energy crisis, which has pushed up sovereign yields and weakened the pound. Indeed, markets are very concerned regarding the sustainability of the debt. The credit default swaps were up sharply suggesting that investors perceive a higher sovereign risk. The Bank of England had to revise its quantitative tightening and started quantitative easing by buying long-term debt to limit the rise in rates. The market is now pricing a terminal rate of 5.5% compared to more than 6% anticipated at the end of September. At its November meeting, the Bank of England should raise rates by 100bps which would bring the current target rate to 3.25%. The main fear is regarding economic activity. In September, the PMI Composite reached a 20-year low. Companies highlight the negative impact of high prices and the darkened economic horizon that weigh on customer spending. All in all, we think that most of the bad news are now priced. It will however take quite some time before markets are confident that the inflation will come down and that economic activity stabilizes. **We revise our targets 3 and 12 months from 0.86 to 0.90 (value of one euro). Against the dollar we expect 1.11 and 1.20 (value of one GBP).**

EURUSD: LOOK FOR A GRADUAL EURO RECOVERY



EURGBP: STABILIZATION AFTER THE FALL



The Yen should finally recover

The Bank of Japan (BOJ) maintained its key interest rate at -0.1% and kept the same rhetoric that it would not change rates until inflation is structurally above 2%. In addition, the Bank of Japan will maintain its pandemic relief loan program until March although it was supposed to stop in September. In fact, according to the BOJ, the current macroeconomic situation presents downside risks for Japan and the BOJ thus maintains an accommodative monetary policy.

The BOJ intervened to sell 19.7 billion dollars and buy yen at the end of September in order to defend its currency. This had only a temporary effect and the YEN then depreciated again.

The Japan Composite PMI reached 51 in September versus 49.4 in August driven by new orders and employment. Businesses continue to highlight increasing inputs costs.

We downgrade our outlook on the Yen. **We now target 145 (value of one dollar) on a 3-month horizon compared to 140 previously and 135 on a 12-month horizon compared to 130 previously. Compared to current levels, we are thus neutral at 3 months and positive on the Yen over the next 12 months.**

Chinese currency should gradually recover

The Chinese currency lost around 3% against the dollar over September due to the monetary policy expectations and the risk-off environment.

China is still penalized by its zero-Covid policy which limits its exports and therefore its current account. Moreover, the Chinese manufacturing PMI further deteriorated from 49.5 in August to 48.1 in September. New orders and exports were at their lowest levels in several months.

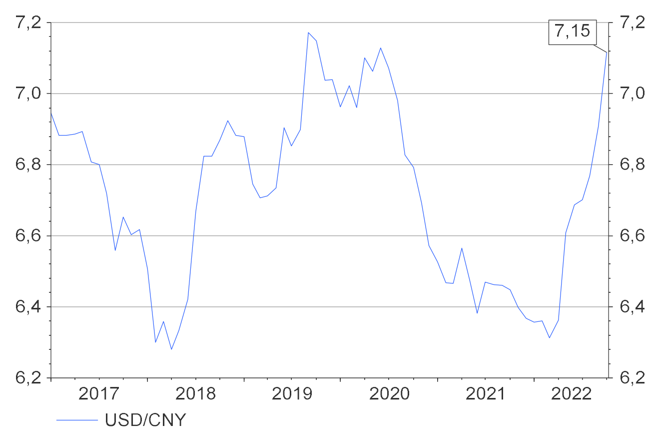
After slightly lowering rates in August, the People's Bank of China is expected to pause in further declines. Rates are more attractive in the US which has led to outflows on Chinese debt and continue to add downward pressure on the Chinese currency.

The party congress in mid-October should announce a change in the Covid policy. We also expect more economic stimulus measures. This should lead to a gradual improvement later this year.

We remain positive at a 12-month horizon. We now target 7.1 (value of one USD) at 3 months compared to 6.8 previously and 6.7 at 12 months.

USDJPY: RECOVERY AHEAD

USDCNY: POSITIVE OUTLOOK



Australian dollar with less upside potential

The AUD lost 4.27% against the dollar over the last 30 days penalized by global recession fears.

At the meeting on October 4th, the Reserve Bank of Australia (RBA) raised its rates by 25 bps, bringing the cash rate to 2.6%. The market was expecting 50bps and the AUD depreciated initially before recovering. The RBA justifies this decision by the fact that the economy needs rates to rise gradually. The terminal rate is expected to be reached only in August 2024 and to be slightly above 4%.

Inflation should reach 7.75% in 2022 in Australia. This is mainly due to the global environment, although strong domestic demand also contributes. The unemployment rate is indeed very low reaching only 3.5%.

The weak growth in China, highlighted by the latest PMI figures, continue to weigh on the AUD. We believe that the Chinese Communist Party on October 20th will help boost Chinese growth. This should be beneficial for the AUD. The macroeconomic environment over the next year should be more risk-on. This will also benefit the AUD. The upside is however lower due to the lower terminal rate.

We are thus less bullish on the AUD. We revise our 3-month target from 0.72 to 0.66 (value of one AUD) and our 12-month target from 0.74 to 0.70.

Gold with target forecast range 1750-1900

Gold has had a tumultuous year, rallying close to a record in March after Russia invaded Ukraine, then slumping as the Fed toughened its approach to quelling the fastest inflation in decades. The non-interest-bearing metal suffered from the strong rise in real yields (the US 10-year real yield rose from -1% in March to +1,3%). The record strength of the US currency was also a major headwind.

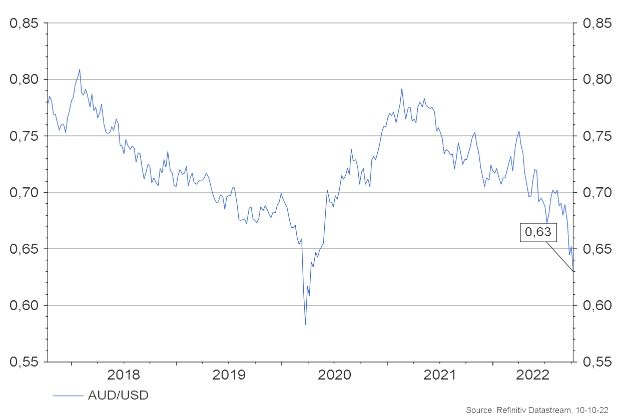
Despite its recent weakness, the bullion has proven to be a good diversifier, up 5% in euros year to date.

In the immediate future, gold could remain vulnerable to the hawkish rhetoric of Fed Chair Jerome Powell who pledged to crush inflation even if it is painful for the economy and to a further strengthening of the US currency. From a technical view, gold is approaching oversold territory.

We expect the gold price to rebound as the US economy weakens, yields stabilize, and the dollar starts to weaken. Gold should regain its lustre as a hedge against stagflation risks when the real rates and strong USD headwinds will abate. Demand from Emerging countries central banks should increase while the post-COVID recovery of the jewellery sector in China and India should also help.

Gold remains our preferred hedge against tail risks. Our 12m target range is $1750-1900.

AUDUSD WITH LESS UPSIDE POTENTIAL



GOLD: APPRECIATION POTENTIAL

CONNECT WITH US

wealthmanagement.bnpparibas

BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world