International Commentary — September 23, 2022

Lights, Camera...Action! Central Banks Take Center Stage

Summary

Central banks were front and center this week, as major institutions such as the Federal Reserve, Bank of Japan (BoJ) and Bank of England (BoE) met to assess monetary policy in their respective economies. At a high level, policymakers generally communicated a hawkish outlook for monetary policy, although the Fed's updated "Dot Plot" garnered the most attention and resulted in renewed volatility across global financial markets. However, the BoJ's commitment to accommodative monetary policy and FX intervention from the Ministry of Finance were also notable, while U.K. financial markets tumbled in the aftermath of the BoE announcement and government fiscal stimulus.

Heading into this week, we believed the U.S. dollar would continue to strengthen through the end of this year. After the events of this week, we have increased conviction in that view, and now believe dollar strength could continue into the early part of 2023. We will make a more formal assessment of currency markets and provide updated exchange rate forecasts in our *September International Economic Outlook,* although as of now, we are likely to extend our dollar strength view into Q1-2023.

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Hawkish Central Banks Abound, but Dollar to Press on

Heading into this week, the schedule was unusually packed with a myriad of central bank meetings. Not only did the Fed offer its September assessment of monetary policy, but many other G10 institutions as well as policymakers across the emerging markets met to determine monetary policy for their respective economies. Typically, the Fed takes center stage and has the most influence over the path of global financial markets. This week was no different; however, monetary policy decisions in Japan and the U.K. proved to be influential as well. And, in the emerging markets, interest rate decisions from some major developing central banks show that the path for monetary policy could be starting to diverge from the Fed even more noticeably than has been the case to date. As far as the Fed, our U.S. economics colleagues shared their thoughts in the immediate aftermath of the FOMC rate decision. In summary, our teammates believe **the Fed delivered a hawkish 75 bps rate hike this week**. Fed Chair Powell delivered a clear message that the committee is focused on containing inflation and bringing price growth back to its 2% target. Also, the Fed's updated “Dot Plot” revealed policymakers expect the Fed funds rate to rise an additional 125 bps by the end of this year and for rate hikes to continue in 2023, a more hawkish rate outlook than financial markets were pricing heading into the meeting.

Aside from the Fed, another central bank that caught the attention of market participants this week was the Bank of Japan (BoJ). As expected, the BoJ left monetary policy settings unchanged; however, the communication around the decision was widely interpreted as dovish. In his commentary, Governor Kuroda suggested that rate hikes may not materialize for two or three years, and that the existing yield curve control policy is unlikely to change for the time being. Kuroda's justification for accommodative monetary policy comes from uninspiring local growth and inflation dynamics, which we acknowledge are valid rationales. We believe Japan's growth prospects are somewhat limited for the next few years, and that inflation should revert to below the BoJ's target in 2023. Taking Kuroda's comments and mixing them with our view on Japan's economy, we see no reason to change our forecast profile for the Bank of Japan's policy and continue to believe the BoJ will be the only central bank with negative policy rates going forward. With the Fed raising interest rates and the BoJ on hold, diverging paths for monetary policy should continue to place depreciation pressure on the yen. We do, however, note that Japan's Ministry of Finance took action this week by intervening in FX markets for the first time since the 1990s in an effort to support the yen. The immediate reaction to the intervention announcement facilitated a sharp rally in the Japanese currency and brought the yen back from record low levels against the dollar. However, **we view BoJ intervention as only a temporary respite for the yen**. In our view, as long as the paths for monetary policy between the Fed and BoJ continue to diverge and interest rate differentials widen, **the bias remains for the yen to continue to weaken and retest lows in the near future**.

The Bank of England (BoE) also met this week when policymakers lifted interest rates another 50 bps and took its base rate to 2.25%, while also delivering a couple of surprises. To that point, BoE policymakers updated their economic forecasts with their latest inflation projection, garnering attention. According to the BoE, new Prime Minister Truss' policy to cap household energy prices should bring inflation lower in the coming months. The central bank's forecast suggests inflation should now peak lower than previously expected, which in our view, should at least offer some assistance to the Bank of England in its fight against inflation. Even so, the decision to increase interest rates by “only” 50 bps was finely balanced, with three policymakers voting in favor of a larger 75 bps increase. The Bank of England also noted the government would announce fiscal support following its monetary policy announcement, which it would take into account at upcoming meetings. As far as fiscal stimulus, the government announced series of tax cuts and regulatory reforms that will cost £161 billion over the next five years. **Against this backdrop, we now expect the Bank of England to hike its policy rate by a larger 75 bps at its next meeting in November.** Still, we believe this larger rate hike will prove to be a one-off. As the U.K. economic slowdown crystallizes and inflation peaks, **we expect the BoE to revert to a 50 bps increase in December, and deliver a final 25 bps rate increase at its first meeting in 2023, which would see the policy rate peak at 3.75%.** Even this faster pace of tightening would still lag the rate of increase from the Federal Reserve, and fall short of Bank of England tightening priced by financial markets as participants anticipate a policy rate peak closer to 5.50%. Accordingly, as the Bank of England “under delivers” relative to these expectations, we expect downward pressure on the British pound to persist.

Outside the G10, multiple emerging market central banks met this week; however, we choose to focus on just two: the Brazilian Central Bank and the Central Bank of Turkey. As far as the Brazilian Central

Bank (BCB), policymakers decided to keep policy settings unchanged; however, we viewed this decision as still having hawkish undertones. In the BCB's official statement, policymakers comment they will “be vigilant” and that they “will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected.” While the BCB's tightening cycle is paused for now, the tone of the statement leads us to believe the door is still open for potential rate hikes, especially if core inflation does not exhibit signs of trending lower. In our view, the BCB tightening cycle is likely over; however, we believe the timing of rate cuts could be pushed back into Q2-2023. Regardless of the timing for rate cuts, keeping monetary policy steady for the next few quarters now puts the trajectory of BCB monetary policy at odds with the path of Fed monetary policy. In our view, **diverging paths for monetary policy, in addition to election related risks, should also place depreciation pressure on the Brazilian real over the next few quarters**. The same can be said for the Central Bank of Turkey, although Turkish monetary authorities opted for *cutting* interest rates 100 bps despite local inflation trending above 80% year-over-year. We can reduce the decision to lower interest rates as President Erdogan influencing monetary policy decisions and implementing his unorthodox view that lower interest rates leads to lower inflation (a view that is not accepted by virtually all market participants). Turkish monetary authorities have struggled with independence, and going forward, we believe additional interest rate cuts are likely as Erdogan seems to have complete and total influence over monetary policy decisions. As the Turkish central bank continues to ease monetary policy in an environment of Fed rate hikes, the **Turkish lira should continue to reach record lows against the U.S. dollar**, eventually reaching TRY21.00 by the end of this year.

The takeaways from this week's central bank bonanza are clear to us. With the FOMC turning even more hawkish, combined with foreign central banks likely not able to keep pace with the Fed, **the U.S. dollar should continue to strengthen**. Right now, we forecast broad dollar strength against most G10 and emerging market currencies through the end of this year. This week has given us increased conviction in that view. In addition, prior to this week, we felt the U.S. dollar could peak in Q4-2022; however, we now believe risks to our dollar view are tilted towards further upside**. Given the hawkish Fed outlook on interest rates, dollar strength could persist into early 2023**. The dollar's relentless rise should be most robust against the emerging market currencies, but risk sensitive currencies like the Australian and New Zealand dollar could also experience renewed downside. While we will perform a more robust assessment of currency markets and formally update our exchange rate forecasts in our *September International Economic Outlook*, as of now, we are likely to extend our view of continuing U.S. dollar strength into early 2023.

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