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TALKING HEADS PODCAST

By **Daniel Morris,** Chief Market Strategist I **John Bradley,** Head of Foreign Exchange

MAKE WAY, GREENBACK, IT IS TIME FOR THE EURO AND THE YEN

Daniel Marris: Hello and welcome to the BNP Paribas Asset Management Talking heads podcast. Every week, Talking heads will bring you in-depth insights and analysis on the topics that really matter to investors. In this episode, we'll be discussing currencies. I'm Daniel Morris, chief market strategist. I'm delighted to be joined by John Bradley, head of FX. Welcome, John. Happy New Year and thanks for joining me.

John Bradley: Thanks. Happy New Year to you as well.

Daniel Morris: We've had volatility in every market, certainly just as much, if not more so in currencies and are now eager to think about what 2023 might hold. The at least initial surprising strength of the US dollar seems to be reversing. We've gone from at one point the dollar being up about 20% on the DXY index to – since September of last year – down about 10%. Is it going to continue? What's next and what's driving the big moves?

John Bradley: 2022 was a super-interesting year in foreign exchange, but specifically the dollar was the dominant theme. And that was mostly driven by the quick repricing that we saw in the path of Federal Reserve interest rates. Fixed income volatility then fed into other risky assets. The dollar was the big beneficiary. Volatility is one of the high-yielding hedges out there. That dynamic was the primary driver of dollar strength last year. And it feels like as we go into 2023, fixed income volatility has started to die down. We don't expect to see the kind of consistent bid to the dollar that we saw in 2022.

As you mentioned, we've already seen a sizable correction from the highs from about three months ago, by about 10%, on the dollar index and even a little bit more on a lot of the emerging market currency pairs. For example, anything that is going to be benefiting from a reopening in China seems to have outperformed over the last couple of months. Going into 2023, we expect more volatility, but also more differentiation within FX markets. So instead of it just being a dominant dollar theme, there's going to be a lot more interest on some of the crosses this year.

Daniel Morris: Picking up on that, last year's story was really as much about dollar strength as opposed to other currencies necessarily being weak. If we think about the euro and sterling, what are the supports, if any, for strength on their side, driven by domestic factors as opposed to just the dollar? Certainly if we think of the ECB, they'd probably be quite happy to see the euro strengthening. That can reduce some of the worries I'm sure they have about inflation.

John Bradley: In the G10 space, our two favourite currencies would be euro and yen. The euro specifically benefits from a couple of dynamics. First of all, it will be a beneficiary of the reopening in China. Obviously, China is a big export partner for Europe. China reopening should see a boost to exports and improvement on the terms of trade. Also on the terms of trade, we've seen a big correction from the highs in natural gas and oil prices that we saw last year. The European Union is a big importer of energy, so the terms of trade took a big hit last year. We've seen a marked improvement on that front over the last few months. We expect energy prices to remain relatively contained in 2023. We do expect higher energy prices, but nothing along the lines of what we saw in in the first half of 2022. In addition, the ECB reaction function has been much more hawkish than the market would have expected six to nine months ago. So it looks like in 2023, the ECB is likely to be one of the more hawkish and more active of the central banks, which should be supportive of the euro.

Daniel Morris: If we pick up on the yen, the Bank of Japan surprised with some tweaks to their yield curve control programme. That raises the question, what's next and probably just importantly, when that might happen. What's your expectation?

John Bradley: It does feel like the BoJ has changed its yield curve control policy and with the change in leadership at the BoJ, with [governor] Kuroda leaving in early April, we expect that process to continue. The question, as always in markets is often about timing. As you said, the market was taken by surprise in December. So now, there's some questions about a faster pace of change in yield curve control. The market has now become excited that we'll see another change at the end of January at the next BoJ meeting. We don't see it happening that quickly. There's likely to be a further widening of yield curve control at the March meeting, ahead of Kuroda's departure and perhaps actual rate hikes towards the end of 2023.

Daniel Morris: John, thanks very much for joining me.

John Bradley: Thank you for having me.