Commentary

7orca

FX Market Report Q2 2023

Inflation, recessionary tendencies and central bank policy – the main issues that moved the foreign exchange markets

Authors

Jasper Düx, CIO
Maximilian Kühl, Head of Research

Jasper Düx
CIO

As Chief Investment Officer, Jasper Duex is responsible for the development and implementation of the investment processes and has the global responsibility for the performance and the implementation.

Maximilian Kühl
Head of Research

As Head of Research, Maximilian Kühl and his team are responsible for all research activities in Quantitative and Economic Research at 7orca. He has been working in analytical positions in the financial sector for more than 5 years.

Highlights

- In our chapter on global currency markets, we explain what the new phase of the interest rate cycle entails for FX markets
- In the section on the Eurozone and the US, the authors shed light on how the withdrawal of li-quidity from the capital market is intended to fight inflation and why the result is likely to be a stronger US dollar vs. the euro
- We explain why the UK is one of the weakest economies in the G20 countries and why the British pound will nevertheless become more expensive
- In Japan, we are surprised by the stoic continuation of ultra-loose monetary policy, which further weakens the yen

7orca Asset Management AG

Am Sandtorkai 77
20457 Hamburg
Telephone: +49 40 3346046-0
E-Mail: info@7orca.com

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1 Global FX markets at a glance

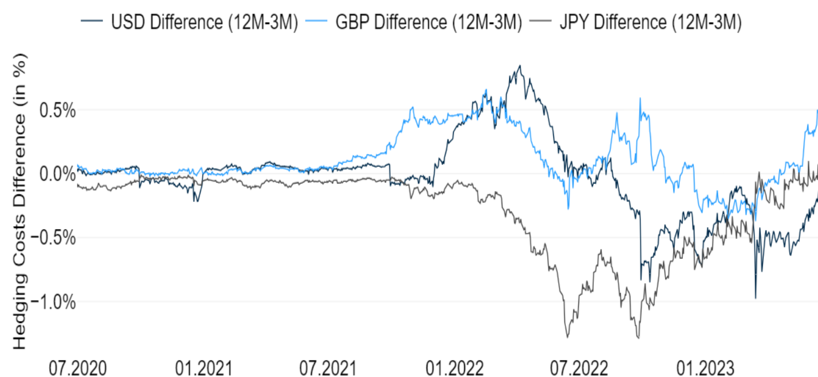
1.1 Monetary policy

Interest rate pause, not peak

A new phase of the interest rate cycle has begun. At its June meeting, the Fed refrained from another rate hike for the first time in 10 FOMC meetings. However, this pause in interest rates does not imply that the interest rate peak has been reached. The Fed plans two more 25 basis point rate hikes over the course of the year. This reflects a global trend. After pauses in Canada and Australia, the central banks acted again in their last interest rate meetings and raised their respective key interest rates by 25 basis points. Figure 1 illustrates the latest trends. A value above 0% signals a tighter future mone-tary policy abroad vis-à-vis the Eurozone. A value below indicates an anticipated narro-wing of interest rate differentials.

- The convergence of interest rates in Europe to the US is largely priced out. The Fed is ex-pected to implement interest rate steps similar to those of the ECB.
- In the UK, where interest rates must continue to rise sharply, a more aggressive policy by the Bank of England can also be expected to con-tinue.
- In Japan, the high interest rate differential is stabilising. Not much is expected from the Bank of Japan from a monetary perspective

Figure 1 | Price difference of 12-month and 3-month hedges



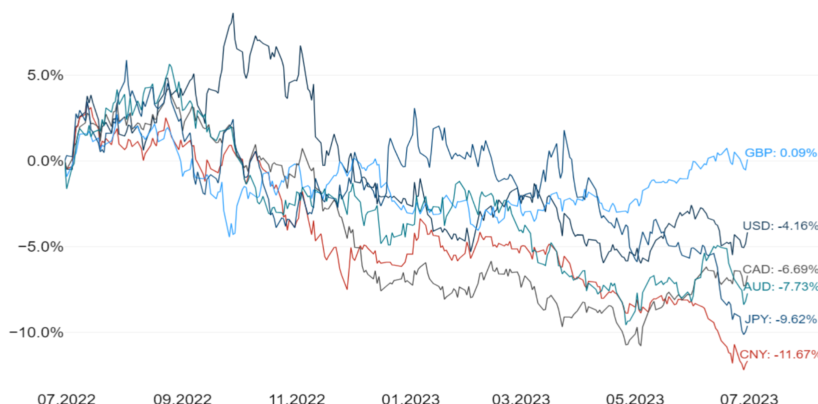
Source: 7orca Asset Management AG, Bloomberg (01.07.2022 - 30.06.2023)

1.2 Economy

Dark clouds on the horizon

Global economic growth continues to slow. The Fed raised the US economic forecasts for the current year by 0.6 percentage points. In the UK, forecasts vary wbetween stagnation and recession. The Euro-zone has formally entered a technical recession, driven by economically weak Germany. The Chinese economy is in a weak shape in real terms despite high hopes of a post-covid recovery. Exports fell recently, the trade surplus narrowed and industrial production contracted. Meanwhile, the Bank of China was forced to cut key interest rates, putting further pressure on the battered currency.

Figure. 2 | Development of various currency pairs against the euro



Source: 7orca Asset Management AG, Bloomberg (01.07.2022 - 30.06.2023)

Most countries are currently in stagnation. This is a positive surprise against the background of the partly very gloomy forecasts and multiple macroeconomic and geopolitical shocks. On the other hand, the economic situation opens up for a more aggressive monetary policy. In the coming months, special focus will be placed on real economic developments. If the relevant real economic indicators turn negative, the end of the interest rate cycle is approaching.

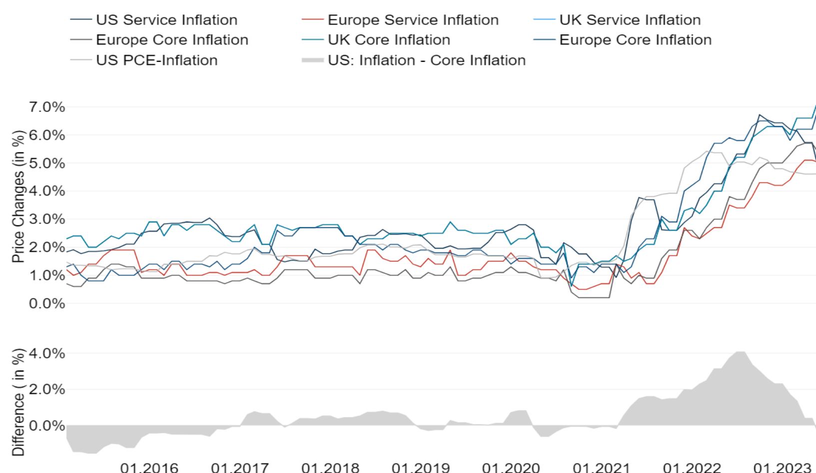
1.3 Price development

Inflation easing - all-clear?

The trend in price development is that the inflation rate in many countries is falling below the core inflation rate. The reason for this lies, among other things, in a price decline in the volatile energy component and illustrates the difficult task central banks are now facing. From the central bankers' perspective, prices in the energy market are exogenous, i.e., they cannot be controlled. However, within their mandate is the reduction of the underlying price trend via the demand side. This continues to be overheated in many countries, which was recently illustrated by a renewed rise in core inflation, for example in the UK (7.1%). The key factor for core inflation is the very dynamic wage development, which is currently above the increase in productivity in most economies.

In the service sector, the passing on of higher prices to consumers can be observed. Here, wage costs take up a high share of total costs. The central banks currently must look through the rapidly falling inflation rate and break the momentum behind it. Further interest rate increases, considering the economic development, are therefore to be expected.

Figure 3 | Development of various inflation time series



Source: 7orca Asset Management AG, Bloomberg (01.07.2015 - 30.06.2023)

2 Europe and the USA

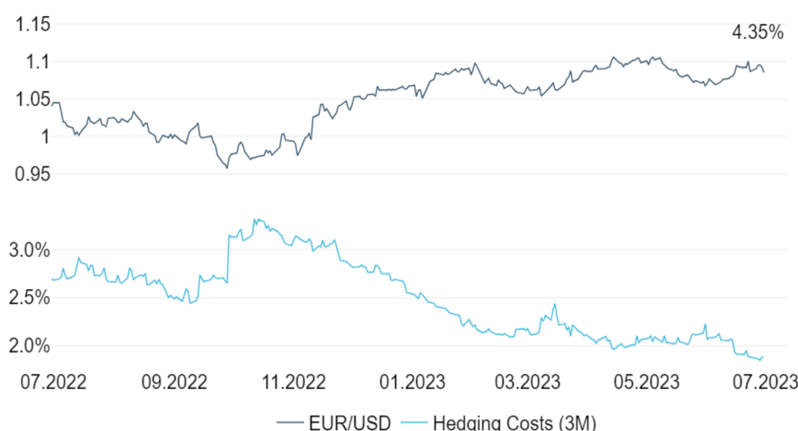
„Are we done? Have we finished the journey? No, we are not at destination. Do we still have ground to cover? Yes, we have ground to cover." Christine Lagarde, ECB President, 15.06.2023

2.1 Monetary policy

Quantitative Tightening on both sides of the Atlantic

The balance sheet reduction programmes (quantitative tightening) to manage longer-term interest rates are being implemented with a new vehemence. The unwinding of the asset purchase programme is reaching a higher tempo in Europe, the maturing papers are now no longer substituted by new pur-cha-ses. After the central bank balance sheet in the US briefly grew again due to the emergency aid in the wake of the bank insolvencies, the reduction is now being continued again. The volume of this regular reduction exceeds that of the ECB. However, the effects of such a programme are highly un-certain due to the lack of historical examples. Initial evidence suggests at least a decline in lending and thus the desired effect of a reduction in demand. Monetary policy in the US continues to be more restrictive than in Europe, also due to the communicated further increase in key interest rates in the course of the year. Even if Lagarde communicates a stricter European interest rate policy, it is ques-tionable to what extent the already weakening European economy can continue to support these steps. A stronger US dollar against the euro seems realistic.

Figure 4 | Basic market data EUR/USD



2.2 Business cycle & fiscal policy

Slight recession in the Eurozone, US still robust

The Eurozone is in a (mild) recession. After two quarters of economic contraction, the question is how high the potential for interest rate hikes is in this situation. The economic weakness is driven in partic-ular by Germany, which recorded a GDP decline of -0.3% in the last quarter and -0.5% in the previous quarter. In this context, the ifo economic index fell to 88.5 points. The main reason for this was the negative expectations (83.6) in the boardrooms of German companies. The gap between the service and manufacturing sectors continues to widen. The corresponding purchasing managers' indices in Europe were more than 10 points apart in May, with the manufacturing sector (44.8) clearly below the expansion threshold of 50.

In the US, the past quarter was also marked by discussions about raising the debt ceiling and the impending insolvency of the US government. In this context, the liquid assets of the US Treasury were almost completely used up. In the Fed's „General Account", where an average of USD 500 billion is stored, less than USD 50 billion was deposited at the low point. The difference is currently and in the coming months being made up by debt financing. This will increase the supply of US government bonds, should further raise their yields, at least in the short term, and will put further pressure on the budget.

The overall economic situation in the US is unexpectedly robust despite the political instabilities that have occurred in the meantime. The Fed revised the GDP outlook for 2023 to 1%. This means that the US economy is still on an expansionary course, which is also thanks to a very strong service sector. The labour market remains overheated. NFP has averaged over 300,000 additional jobs per month since the beginning of the year and there are 1.6 unfilled jobs for every unemployed person.

In a direct comparison, the US economy offers greater potential to raise interest rates further than the Eurozone. Structurally, the economic side has a negative impact on the EUR/USD.

2.3 Price developments

Easing in the USA, European price increase

Inflation fell in May in both Europe (6.1%, previously 7%) and the US (4%, previously 4.9%). In the US, the decline in prices is now visible in many important indicators. For example, according to the New York Fed, consumers' 3-year inflation expectations fell from a peak of over 4% to below 3% in May. This value was only slightly above the pre-Covid average. In the same survey, a record

58% of respondents said that lending conditions were more difficult or much more difficult year-on-year. This cooling in the credit market is a positive sign for the demand side of the inflation equation. The indi-cators usually run inversely. Core inflation also fell to 5.3%, but the decline is a little sluggish. Worryingly, the Fed's preferred core PCE index (core rate of private consumption expenditure) remains high, recently falling only slightly by 10 basis points, and has remained at the 4.6% level for several months. It remains questionable whether the current interest rate level is sufficiently restrictive to achieve the 2% target on a sustainable basis. This is especially true since the decline in consumer prices is currently driven by the decline in volatile energy prices (-11.7%).

Figure 5 | Relationship between perceived credit conditions and consumer inflation expectations in the US

Source: Federal Reserve Bank of New York (30.06.2023)

2.4 Overall assessment EUR/USD

A renewed Fed action, an already recessionary Eurozone and a more rapidly retreating price trend in the US argue for a weaker EUR/USD exchange rate in the medium term.

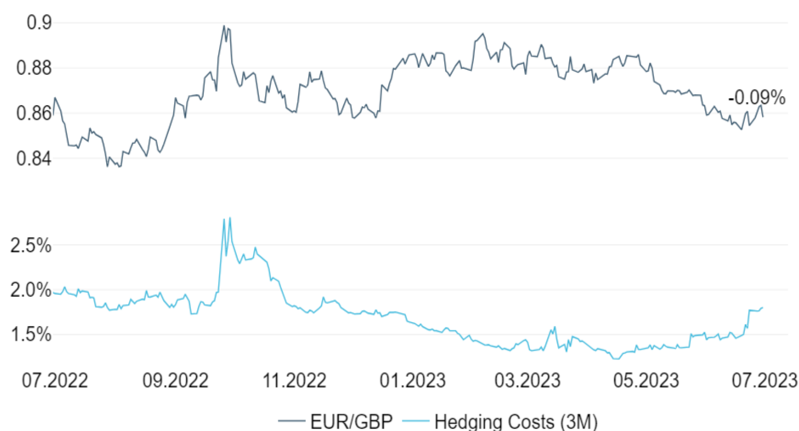
3 Great Britain

3.1 Monetary policy

Stronger pound relative to the euro possible

In view of rampant inflation, the Bank of England (BoE) had to raise the interest rate step again to 50 basis points in the last interest rate setting. With a key interest rate of 5% (main refinancing rate in Europe at 4%) and hedging costs for a 12-month term of over 2%, further key rate hikes by the BoE are also priced in, which should exceed those of the ECB. However, no substantial long-term appre-ciation potential of the British pound can be derived from this. Interest rates also serve to compen-sate for inflation. If the latter rises disproportionately, the relative attractiveness of the currency falls. The real interest rate continues to be negative in this context. In the past quarter, the assessment on the capital market was different - the pound sterling initially appreciated. In an increasingly unstable environment, the validity of this assessment is questionable. The interest rate outlook thus points to a stronger British pound against the euro due to the Bank of England's more offensive outlook. How-ever, this component must be examined in conjunction with the factors described below.

Figure 6 | Basismarktdaten EUR/GBP



Source: 7orca Asset Management AG, Bloomberg (01.07.2022 - 30.06.2023)

3.2 Economy

Great Britain tops the list from behind

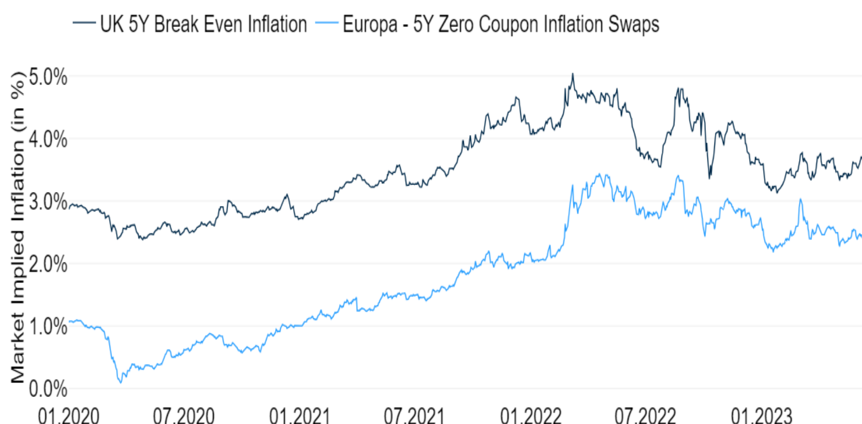
The United Kingdom is one of the worst performers among the G20 countries (behind only Germany and Russia). Some of the previously seemingly more stable leading indicators, such as purchasing managers' indices, contracted again in the last measurement. Remarkable in this context is the decline in the service sector (-1.5 points). Industrial production also fell 0.3 percentage points from the previ-ous month and consumer confidence is deep in negative territory at -24. It is alarming that economic weakness is being met with sharply rising prices, thus curtailing the Bank of England's potential to raise interest ra-tes. From an economic perspective, a negative picture for the British economy and the pound is increasingly crystallising.

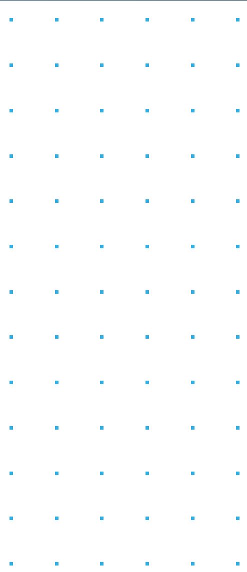
3.3 Price developments

Inflation and wage spiral depress the value of the pound

Inflation in the UK is too high and now entrenched in expectations with core inflation above 7%. This is the „worst case scenario" for any central banker, as inflation expectations are a good predictor of actual inflation. If the former settles, there is a high risk that the latter will remain high as well. In the markets, long-term inflation expectations are again priced above 4%. This value is at the levels of last year when Theresa May briefly panicked the markets with an unsound budget policy. In direct compar-ison with the eurozone, where long-term expectations are anchored near 2%, this is alarming. Wage growth, which remains well above productivity growth, reinforces this trend. In direct com-parison to the Eurozone, this higher inflationary environment with a negative outlook is reducing the value of the British pound

Figure 7 | : Inflation data priced into the market





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3.4 Overall assessment EUR/GBP

The UK is a global negative outlier in price development. The Bank of England reacted by tightening monetary policy more than the Eurozone. Economically, both the UK and the Eurozone are on the brink of recession. The unstable price outlook in the UK is driving an overall negative view on sterling.

4 Japan

4.1 Monetary policy

Never change a „working“ system

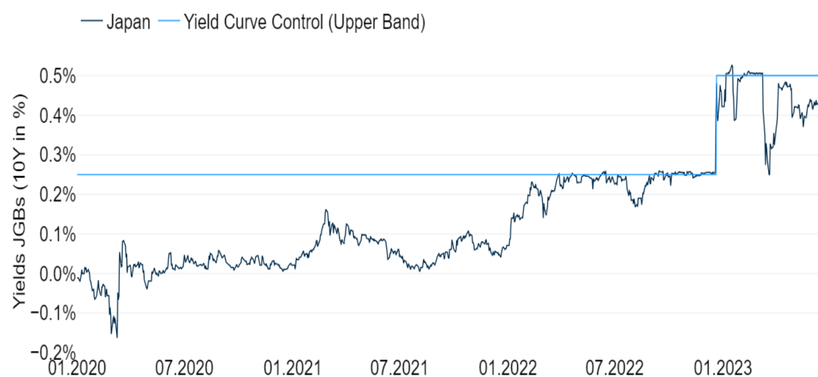
The new central bank chief of the Bank of Japan Kazuo Ueda stoically communicates the continuation of the expansionary monetary policy. Japan continues to play the role of a global outlier in terms of monetary policy. The interim review of this policy is set for more than a year. A short-term deviation from the current course thus seems unlikely.

Figure 8 | Base market data EUR/JPY

Source: 7orca Asset Management AG, Bloomberg (01.07.2022 - 30.06.2023)

The negative interest rates at the short end of the interest rate structure and the interest rate control at the long end continue to lead to substantial depreciation pressure on the Japanese yen. Hedging returns are stable at a high level across the interest rate structure, so that a high return can continue to be generated from the interest rate component of a yen hedge. Yield curve control remains intact and speculative pressures have been noticeably reduced as Ueda communicated a clear commitment to the current policy.

Figure 9 | Yield on 10-year Japanese government bonds as an indicator for maintaining yield curve controlv



Source: Bloomberg (01.07.2022 - 30.06.2023)

4.2 Economy

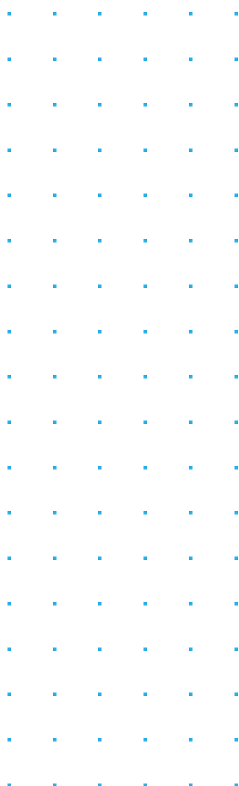
Local support, global headwind

Supported by expansionary monetary policy, the Japanese economy is robust. Past economic growth was 0.7% in the first quarter of 2023, gaining momentum and exceeding market expectations. Unemployment is currently only 2.6% and the manufacturing sector seems solidly positioned. Howev-er, a bigger factor of uncertainty is the slowing export volume (-12% in May), which is rooted in the weakening global economy. From a real economic perspective, the overall situation in Japan is more optimistic than in Europe, but weak exports are depreciating the yen.

4.3 Price developments

Yen under pressure with inflation above 4%

The central indicator for the Bank of Japan‘s (BoJ) interest rate policy is infla-tion excluding fresh goods and energy, which is conceptually comparable to European core inflation. With a value of 4.3% in the meantime, the declared target of a temporally stable value of 2% has been clearly ex-ceeded. The jus-tification for the lack of adjustment on the part of the central bank is, among other things, its forecast, which sees core inflation falling to 1.8% this year. This puts the BoJ at the lower end of the available projections. For example, economists at Goldman Sachs see price growth at 2.8% over the same period.



The central bank's past forecasting errors suggest greater realism in the higher figure. The failure of monetary policy to adjust to an increasingly inflationary trend provides negative price impulses on the Japanese yen.

4.4 Overall assessment EUR/JPY

With inflation still elevated and monetary policy expansionary, including high interest rate differentials, the outlook for the Japanese yen remains structurally negative.

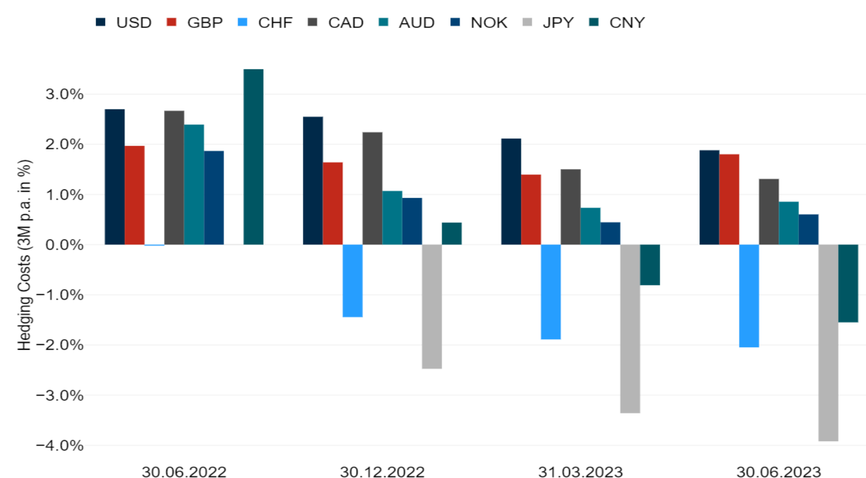
Data

Tabel 1 | Overview of performance at various reporting dates

Currency	YTD	1 Month	3 Months	1 Year
USD	-1,56%	-1,63%	0,15%	-4,16%
GBP	3,27%	0,59%	2,35%	0,09%
CHF	0,97%	-0,60%	1,97%	2,07%
CAD	0,61%	1,20%	2,26%	-6,69%
AUD	-4,13%	0,54%	-0,91%	-7,73%
NZD	-5,39%	-0,35%	-2,72%	-6,18%
NOK	-9,94%	2,91%	-2,65%	-11,50%
SEK	-5,36%	-1,47%	-4,63%	-9,23%
JPY	-10,99%	-4,77%	-7,66%	-9,62%
CNY	-6,59%	-3,80%	-5,26%	-11,67%

Source: Bloomberg (30.06.2023)

Figure 10 | Overview of hedging cost development at different reporting dates



Source: 7orca Asset Management AG, Bloomberg (30.06.2023)

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Disclaimer

The strategy presented in this document for hedging currency risks (currency overlay management) is aimed exclusively at professional investors according to the German Securities Trading Act (WpHG) and can only be implemented for such investors (typically in a fund structure). All assumptions, forecasts and disclosures are based on the standardised set-up of the active currency overlay management strategy, which was carried out at average market costs. Further information on this standard investment process can be found in the Generic RfP, which is available from 7orca Asset Management AG upon request. Due to the different investor needs and situations as well as the resulting specific pricing, further individual costs for administration and custody are not taken into account. However, 7orca Asset Management AG will be pleased to provide you with a specific offer that reflects your individual requirements and conditions. The investment strategy of an active currency hedging has a trend-following character. It should therefore lead to the same results under the same market conditions. Since market conditions repeat themselves regularly, but not in identical form, the hedge ratios and performance indicators listed in this document can illustrate the characteristics of our strategy. However, they refer to past price developments of currency pairs and are therefore not a reliable indicator of future results. All information in this document has been compiled to the best of our knowledge based on the data available to us. However, no civil liability can be assumed in this respect. References to specific financial instruments are purely exem-plary and should under no circumstances be construed as recommendations in the sense of investment advice. A publication of 7orca Asset Management AG. (30.06.2023)