2023 FX Outlook: Top trades

16 November 2022

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Executive summary

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We have published our 2023 FX Outlook: The dollar's high wire act in tandem with this report. This 'top trades' report provides a brief summary of the main themes and introduces seven top FX trade ideas for 2023.

Having risen around 25% since the summer of 2021, the dollar has recently taken quite the tumble. For 2023 the question is whether this is the start of a new bear trend or will the factors that drove the dollar to those highs still have a say?

Given that the most liquid FX pair, EUR/USD, was such a large driver of global FX trends in 2022, we use a scenario approach to look at a range of EUR/USD outcomes in 2023 – derived from the expected volatility priced into the FX options market. The range of scenarios and end-2023 FX levels extend from 'Permacrisis', where EUR/USD could be trading at 0.80, to 'Safe and Sound', where EUR/USD could be closer to 1.20.

Key inputs to that scenario approach are factors like: (i) how aggressive the Fed will be; (ii) Ukraine, Europe and energy; (iii) China; and (iv) the overall risk environment. Given ING's house view of the Fed taking rates to 5.00% in early 2023, four quarters of recession in Germany amid higher energy prices, relatively weak Chinese growth and a still difficult equity environment, our baseline view favours softer EUR/USD levels.

But perhaps the strongest message to get across in our outlook is that FX markets in 2023 will see fewer trends and more volatility. We say this because conditions do not look to be in place for a clean dollar trend – no 'risk-on' dollar decline nor 'risk-off' dollar rally. And central banks tightening liquidity conditions through higher policy rates and shrinking balance sheets will only exacerbate the liquidity problems already present in financial markets. Volatility will stay high.

Softening global activity and trade volume growth at less than 2% are likely to limit the gains of pro-cyclical currencies in 2023. EUR/USD could be ending the year near 1.00. If the positive correlation between bonds and equity markets does break down next year, it will likely come through a bond market rally. Our forecast for US 10-year Treasury yields at 2.75% end year will argue for USD/JPY to be trading at 130 or lower.

EUR/USD will set the tone for European currencies in general. We favour the Swiss franc to outperform and sterling to underperform. Scandinavian currencies may continue to struggle with the high volatility environment. Further east, we see scope for the Hungarian forint to be re-assessed positively, while the overvalued Czech koruna and Romanian leu look more vulnerable as FX intervention slows.

In the commodity bloc, the uncertain outcome for China continues to place a question mark over the Australian and New Zealand dollars. We again prefer the Canadian dollar – although how the housing market correction plays out will be a risk. USD/CNY itself may struggle to sustain a move sub-7.00. And in a more mixed FX environment, expect local stories to win out – one of which may be Korean treasury debt being included in world government bond benchmarks – helping the won.

Our top trades for 2023

1 Buy USD/NOK straddle | Options | Target 1X premium

One of our strongest views in our 2023 FX outlook is that liquidity will become more scarce as core central banks tighten into a recession and that volatility will rise. Most exposed to this theme will be the Norwegian krone, which tends to get bounced around on poor liquidity and where USD/NOK trades on the highest volatility in the G10 space. This buy-and-hold, limited-loss strategy positions for further big moves in this pair over the next three months, even though the ultimate direction is far from clear.

Buy USD/NOK 3m delta-neutral straddle (expiry 15/2/23). Cost 6070 NOK pips, strikes 9.9057, priced off USD/NOK spot 9.96 and 3m vol at 15.4%. Expected return 100% of premium outlay. In practise, USD/NOK needs to trade to the 8.70 or 11.10 area.

2 Sell PLN/HUF | Spot | Target 80.0

Budapest will find an agreement with the European Commission in the coming weeks and EU money will start flowing again. We forecast a noticeable improvement in the Hungarian current account deficit and the lowest public deficit in the region next year. The NBH has come a long way and the HUF is more under control now. On the other hand, Warsaw is gearing up for an open confrontation with the EC, Poland will have by far the highest general government deficit in the CEE region for next year, and the NBP is trying in vain to end the hiking cycle, while the peak in inflation is still not in sight.

Sell PLN/HUF forward dated 31/3/2023. Entry level: Sell 50% of notional when spot at 87.00 and sell 50% of notional when spot at 88.00. Target 80.00 end March 2023. Stop loss if spot hits 90.12. Expected return c.9.4%. Trade is carry positive.

3 Sell CNH/KRW | Spot | Target 180

The turn in the risk environment has seen the high beta Korean won deliver some standout gains. CNH/KRW has fallen close to 8% from its highs. Given the very mixed external environment – at least at the start of 2023 – trade ideas will need to be backed by a strong local story. Here, the potential inclusion of Korean treasury bonds into the FTSE WGBI bond index is one such story – with a possible announcement in March 2023. We look to take advantage of a corrective rally in CNH/KRW to position for that move.

Sell CNH/KRW forward dated 31/3/2023. Entry level: sell 50% of notional when spot at 190.00 and sell 50% of notional when spot at 193.00. Target 180 end March 23. Stop loss if spot hits 195.30. Expected return 6%. Trade is carry neutral.

4 Sell GBP/CHF | Spot | Target 1.07

Sterling faces several challenges heading into 2023, not least fiscal consolidation into a recession. The exchange rate is going to have to play the shock-absorber as the new government makes running repairs. If we are reading the tea leaves correctly in Zurich, the SNB will want a stronger nominal Swiss franc to keep the real exchange rate stable. Short GBP/CHF also expresses our distrust of the recent risk rally.

Sell GBP/CHF forward dated 30/12/23. Entry level: Sell 50% of notional when spot at 1.1300 and sell 50% of notional when spot at 1.1500. Target 1.0700 end Dec 23. Stop loss if spot hits 1.1630. Expected return ~5.4%. Trade is carry negative.

5 Buy Knock-In EUR/USD put | Options | Target 4x premium

Having been the most crowded trade in recent buyside surveys, long dollar positions have suffered badly on the re-pricing of the risk environment – driven by softer US inflation data. This correction may have further to run, especially given the weight of positioning and expectations that US November CPI data, released on 13 December, could be soft too. But we find it unlikely that the Fed will want to pump more air into this risk rally at its 14 December FOMC meeting and EUR/USD could well be ending the year back near parity.

Buy Knock-In EUR put/USD call, expiry 30 Dec 22, strike 1.0300, barrier 1.0600. Premium cost 23 USD pips. Priced off spot 1.0370, implied vol 10.96%. Target 4X premium return or 92 USD pip profit. This is a limited loss strategy.

6 Sell BRL/MXN | Spot | Target 3.50

We have been fans of the Mexican peso for several years, as Banxico effectively chooses to minimise USD/MXN volatility as a policy choice. Continued relative stability in the peso is our call, while Brazil faces greater challenges in 2023 – both on President-elect Lula's welfare plans, but also Brazil's high debt/deficit position. We would decompose this outright trade into the liquid USD/BRL non-deliverable and USD/MXN deliverable forwards.

Sell BRL/MXN forward dated 31/3/2023. Sell 50% of notional when spot at 3.70. Sell 50% of notional when spot at 3.80. Target 3.50 by end March 23. Stop loss if spot hits 3.8325. Expected return ~6%. Trade is carry negative.

7 Buy CAD/SEK | Spot | Target 8.30

CAD and SEK have similar high betas to global risk sentiment, but different exposures to some key risk drivers. We expect gas prices to rise again in the year ahead, which is positive for the gas-exporting CAD and negative for SEK given its exposure to European sentiment. Incidentally, CAD can benefit from its links with the US economy, which should prove more resilient than the European one, and from a higher yield than SEK, which could play a role should risk stabilisation trigger a fresh search for carry.

Buy CAD/SEK forward dated 30/6/2023. Buy 50% of notional when spot at 7.84. Buy 50% of notional when spot at 7.80. Target 8.30 by end June 2023. Stop loss if spot hits 7.68. Expected return c.6.1%. Trade is carry positive.

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