WELLS FARGO

International Commentary — January 21, 2022

International Economic Outlook: January 2022

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Summary

Forecast Changes

- We have made only modest changes to our foreign exchange forecasts, and now see slightly less U.S. dollar strength than previously, after a brief period of greenback consolidation at the start of this year. The British pound, Canadian dollar and Australian dollar are among the G10 currencies we expect will experience less weakness than previously forecast.
- In the emerging markets, political risks have calmed in Peru and Chile, and as a result, we forecast less weakness in each currency. While we still forecast a weaker Brazilian real, encouraging political developments lead us to forecast a more modest depreciation over the course of 2022 and 2023.
- With respect to monetary policy, we see faster Fed tightening than previously, including four rate hikes this year, as well as a start to reducing the size of the balance sheet before year-end. We also see the Reserve Bank of Australia raising rates earlier than previously forecast, with an initial rate hike expected in Q1-2023.

Key Themes

- The U.S. dollar has experienced a brief period of consolidation at the start of 2022, reflecting a soft patch in activity data and after the market spent several months adjusting to a more hawkish Fed policy outlook. However, we expect the greenback's strengthening trend to resume once the Fed starts raising rates and eventually begins to reduce the size of its balance sheet.
- Price pressures remain a key focus for financial markets, with inflation readings globally continuing to firm—and often surprising to the upside. That should see many G10 and emerging market central banks continue to tighten monetary policy this year, and global bond yields trending higher.
- China's economy finished 2021 on a steady note, though COVID, regulatory concerns, and real estate difficulties continue to weigh on the outlook. As a result, we see slower growth for China in 2022 compared to last year, even as Chinese authorities ease monetary policy to cushion the economy.

Federal Reserve's Hawkish Shift Continues

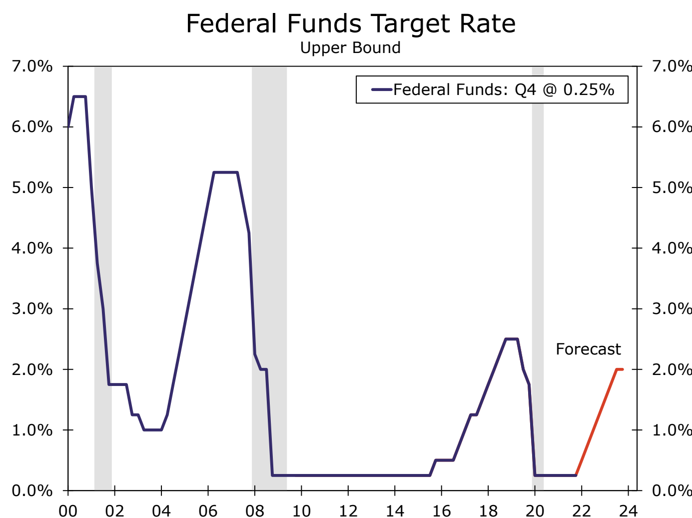
The Federal Reserve's steady shift to a hawkish direction that began in the second half of 2021 has continued in the early part of 2022. Late last year at its December monetary policy meeting, Fed policymakers accelerated the tapering of its bond purchases, saying it would reduce the pace of its bond purchases by $30 billion each month, which would bring them to an end by March 2022. However, the minutes from that monetary policy meeting, which were released earlier this month, revealed a background discussion that was even more hawkish than the Fed's formal announcement. Among other things, the minutes from the December FOMC monetary policy meeting said:

> "Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated."

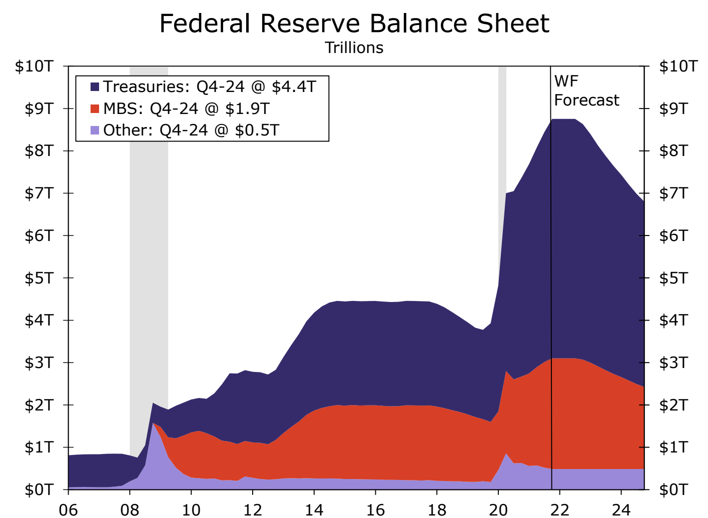
In addition, the minutes indicated:

> "Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate."

Given these hawkish signals, and with CPI inflation having quickened further to 7.0% year-over-year in December, we have again adjusted our outlook for Fed monetary policy to anticipate a faster pace of Fed tightening. **We now expect four 25 bps rate hikes in 2022** (compared to two previously), **with the first likely to come at the March monetary policy meeting**. In addition, **we also expect the Fed to announce in Q3-2022 that it will start shrinking its balance sheet** later this year, initially by a moderate $25 billion per month, but with the pace of reduction growing such that it reaches $100 billion per month by the spring of 2023.



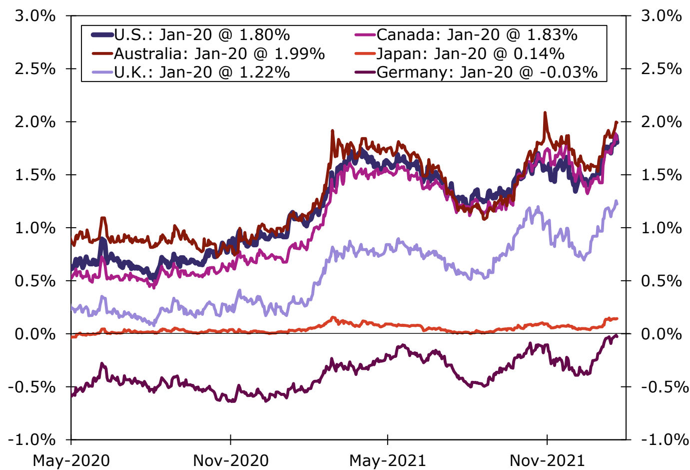
Source: Federal Reserve Board and Wells Fargo Economics



Source: Federal Reserve Board and Wells Fargo Economics

Fed's Hawkish Shift Not Helping the U.S. Dollar...for Now

While the Fed's ongoing hawkish shift should fundamentally be positive for the U.S. dollar, the latest shift has so far offered little support for the greenback in 2022. In part, dollar weakness early this year may reflect some "buy the rumor, sell the fact" dynamics. Another factor could be comments from Fed Chair Powell regarding the direction of U.S. monetary policy. At Powell's confirmation hearing, he indicated the Fed would look to raise interest rates in a way where the U.S. and global economic recovery would not be interrupted. These comments have boosted sentiment toward foreign currencies, especially the more risk-sensitive emerging market currencies. In addition, the relatively high valuation of U.S. equities compared to international equities could also be contributing to capital flows from U.S. to foreign markets. And finally, although the U.S. December CPI was elevated, it came in "as expected", a break from several months of upside surprises and a factor that may have reined in the U.S. dollar to start the year.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Source: Bloomberg Finance L.P. and Wells Fargo Economics

While the U.S. dollar has started 2022 on an underwhelming note, and a temporary pause in the greenback's uptrend is possible during the first quarter of this year, we still believe fundamentals should prove favorable for the U.S. dollar over the longer term. Once the Federal Reserve begins raising interest rates in March, or shortly thereafter, the relative attractiveness of the U.S. dollar should improve and should, we think, support the greenback going forward. In addition, we still view the U.S. economy as a relative outperformer in terms of growth prospects. Economies across the G10 are still lagging the United States, while most developing economies have struggled to gather or maintain momentum since the start of the pandemic. Should, as we expect, market participants begin to focus on country-specific fundamentals, we believe investors will again divert capital back toward U.S. dollar-denominated assets, which should be supportive of the greenback over time.

In addition to these U.S. dollar supportive factors, we also remain of the view that market pricing for monetary policy tightening for some other G10 central banks remains overly aggressive. Accordingly, should those central banks, as we expect, fail to fully deliver on those market expectations, under-delivering on rate hikes should also be a negative influence on some major developed currencies, reinforcing the prospects for U.S. dollar strength over time. Among the central banks where pricing appears aggressive are the Bank of Canada, where markets anticipate 154 bps of rate hikes over the next 12 months versus our forecast for 75 bps, and the Bank of England, where markets anticipate 112 bps of rate hikes over the next 12 months versus our forecast for just 50 bps.

In the emerging markets, local political developments in some economies could also weigh on their respective currencies. Latin American politics shifted sharply left last year, and we believe new policy platforms and political ideologies in countries such as Chile and Peru can still weigh on these currencies. In addition, Presidential elections will take place in Brazil and Colombia this year, and we expect left-leaning politicians to gather significant momentum in the lead up to each vote. Political risk tied to each election should also weigh on the Brazilian and Colombian currencies this year. In the EMEA region, unorthodox policy should continue to weigh on the Turkish lira, while a fragile economy and heightened political risk in South Africa should keep the rand on the back foot. Finally, we note a growing divergence between U.S. monetary policy, and Chinese monetary and liquidity policy. In contrast to the shift to less accommodative policy in the U.S., the People's Bank of China has reduced its Reserve Requirement Ratio in recent months as a means of freeing up liquidity. In the past several days, the central bank also lowered its seven-day reverse repo rate by 10 bps to 2.10% and lowered the one-year MLF lending rate by 10 bps to 2.85%. Given the growing divergence between U.S. and Chinese monetary policy trends, we expect the renminbi to weaken against the U.S. dollar over time, a factor that could weigh on other regional Asian currencies as well. Altogether, we view key monetary policy and political fundamentals as broadly consistent with a stronger U.S. dollar over the medium term.

While foreign exchange markets have not yet paid that much attention to the increasingly hawkish signals from the Federal Reserve, global bond markets certainly have. Government bond yields have surged higher during 2022, and just since the start of this year, U.S. 10-year yields are up 26 bps,

Canadian 10-year yields are up 38 bps, U.K. 10-year yields are up 22 bps and even German 10-year yields are up 12 bps. The surge in yields is in part a reflection of persistent inflationary pressures and rising inflation concerns on the part of investors and central banks. Moreover, as yields have risen, global equity markets have come under pressure at times. In the U.S., the S&P 500 index is down 6% year to date, Japan's Nikkei index in down 4.4% year to date, and pan-European equities are lower. To the extent that upward pressure on global bond yields remains, and equity markets remain somewhat unsettled, the U.S. dollar could garner safe haven support, which would be an additional positive for the greenback.

Global Economic Forecasts

Wells Fargo International Economic Forecast

	GDP				CPI			
	2020	2021	2022	2023	2020	2021	2022	2023
Global (PPP Weights)	-3.1%	5.7%	4.2%	3.1%	3.2%	4.2%	4.6%	3.5%
Advanced Economies[1]	-4.5%	5.2%	4.1%	2.8%	0.7%	3.4%	4.2%	2.1%
United States	-3.4%	5.6%	3.9%	3.1%	1.2%	4.7%	5.4%	2.5%
Eurozone	-6.3%	5.2%	3.9%	2.3%	0.3%	2.6%	3.2%	1.7%
United Kingdom	-9.8%	7.1%	4.1%	2.3%	0.9%	2.6%	4.5%	2.2%
Japan	-4.6%	1.6%	3.7%	1.8%	0.0%	-0.2%	0.5%	0.7%
Canada	-5.3%	4.6%	3.8%	3.0%	0.7%	3.4%	3.4%	2.1%
Switzerland	-2.5%	3.6%	2.9%	2.0%	-0.7%	0.6%	0.9%	0.6%
Australia	-2.4%	4.1%	3.4%	3.3%	0.9%	2.7%	2.5%	2.3%
New Zealand	-2.1%	5.3%	3.4%	2.9%	1.7%	3.7%	3.9%	2.2%
Sweden	-2.8%	4.6%	3.1%	2.2%	0.7%	2.2%	2.1%	1.7%
Norway	-0.8%	4.0%	4.2%	2.1%	1.3%	3.5%	2.3%	1.9%
Developing Economies[1]	-2.1%	6.1%	4.3%	3.4%	5.1%	4.8%	4.9%	4.6%
China	2.3%	8.1%	5.1%	5.2%	2.4%	0.9%	2.1%	2.2%
India	-7.3%	7.8%	9.2%	5.0%	6.2%	5.1%	4.9%	4.7%
Mexico	-8.3%	5.6%	3.0%	2.1%	3.4%	5.7%	5.0%	3.8%
Brazil	-4.1%	4.8%	0.7%	2.0%	3.2%	8.5%	6.0%	3.8%

Forecast as of: January 21, 2022

[1]Aggregated Using PPP Weights

Source: International Monetary Fund and Wells Fargo Economics

Interest Rate Forecasts

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	2022				2023	
	Q1	Q2	Q3	Q4	Q1	Q2
Central Bank Key Policy Rate						
United States	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
Eurozone[1]	-0.50%	-0.50%	-0.50%	-0.50%	-0.50%	-0.50%
United Kingdom	0.25%	0.50%	0.50%	0.75%	0.75%	1.00%
Japan	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
Canada	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%
2-Year Note						
United States	1.20%	1.45%	1.70%	1.90%	2.00%	2.10%
Eurozone[2]	-0.60%	-0.60%	-0.55%	-0.55%	-0.50%	-0.50%
United Kingdom	0.75%	0.90%	1.05%	1.20%	1.30%	1.40%
Japan	-0.10%	-0.10%	-0.10%	-0.05%	-0.05%	-0.05%
Canada	1.05%	1.20%	1.35%	1.50%	1.60%	1.70%
10-Year Note						
United States	1.90%	2.05%	2.15%	2.20%	2.25%	2.30%
Eurozone[2]	-0.05%	-0.05%	0.05%	0.15%	0.30%	0.45%
United Kingdom	1.15%	1.30%	1.40%	1.50%	1.55%	1.60%
Japan	0.15%	0.15%	0.15%	0.20%	0.20%	0.20%
Canada	1.85%	2.05%	2.15%	2.25%	2.30%	2.35%

Forecast as of: January 21, 2022

[1] ECB Deposit Rate [2] German Government Bond Yield

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Currency Forecasts

Currency Pair*	Current rate	Q1-2022	Q2-2022	Q3-2022	Q4-2022	Q1-2023	Q2-2023
G10							
EUR/USD	1.1350	1.1300	1.1100	1.0900	1.0800	1.0700	1.0600
USD/JPY	113.64	114.00	116.00	118.00	120.00	122.00	123.00
GBP/USD	1.3554	1.3400	1.3200	1.3000	1.2900	1.2800	1.2700
USD/CHF	0.9113	0.9150	0.9325	0.9550	0.9675	0.9825	0.9950
USD/CAD	1.2541	1.2600	1.2700	1.2800	1.2900	1.3000	1.3100
AUD/USD	0.7189	0.7200	0.7100	0.7000	0.6800	0.6700	0.6600
NZD/USD	0.6718	0.6700	0.6600	0.6500	0.6400	0.6300	0.6200
USD/NOK	8.9008	8.8500	8.9200	8.9900	8.9825	8.9725	8.9625
USD/SEK	9.1917	9.2025	9.3250	9.4500	9.4900	9.5325	9.5750
Asia							
USD/CNY	6.3381	6.3300	6.3500	6.3700	6.3900	6.4100	6.4300
USD/CNH	6.3406	6.3300	6.3500	6.3700	6.3900	6.4100	6.4300
USD/IDR	14338	14300	14500	14700	14900	15100	15300
USD/INR	74.43	74.50	74.75	75.00	75.25	75.50	75.75
USD/KRW	1194.05	1190.00	1200.00	1210.00	1220.00	1230.00	1240.00
USD/PHP	51.39	51.50	51.75	52.00	52.25	52.50	52.75
USD/SGD	1.3446	1.3400	1.3500	1.3600	1.3700	1.3800	1.3800
USD/TWD	27.70	27.50	27.50	27.75	27.75	28.00	28.00
USD/THB	32.96	32.75	33.00	33.25	33.50	33.75	34.00
Latin America							
USD/BRL	5.4267	5.5000	5.6000	5.7000	5.8000	5.9000	6.0000
USD/CLP	796.61	800.00	820.00	830.00	840.00	850.00	860.00
USD/MXN	20.4548	20.5000	21.0000	21.2500	21.5000	21.7500	22.0000
USD/COP	3962	4000	4100	4150	4200	4250	4300
USD/ARS	104.3655	106.0000	110.0000	114.0000	118.0000	122.0000	126.0000
USD/PEN	3.8322	3.8000	3.8300	3.8500	3.8700	3.8900	3.9100
Eastern Europe/Middle East/Africa							
USD/CZK	21.51	21.75	22.00	22.75	23.00	23.25	23.50
USD/HUF	316.25	318.50	328.75	339.50	347.25	355.25	358.50
USD/PLN	4.0034	4.0275	4.1450	4.2650	4.3525	4.4400	4.4800
USD/RUB	77.19	77.00	78.00	79.00	80.00	81.00	82.00
USD/ILS	3.1441	3.1500	3.2000	3.2200	3.2400	3.2600	3.2800
USD/ZAR	15.1388	15.0000	15.5000	15.7500	16.0000	16.2500	16.5000
USD/TRY	13.4388	14.0000	15.0000	16.0000	17.0000	18.0000	19.0000
Euro Crosses							
EUR/JPY	128.98	128.75	128.75	128.50	129.50	130.50	130.50
EUR/GBP	0.8374	0.8425	0.8400	0.8375	0.8375	0.8350	0.8350
EUR/CHF	1.0343	1.0350	1.0350	1.0400	1.0450	1.0500	1.0550
EUR/NOK	10.1021	10.0000	9.9000	9.8000	9.7000	9.6000	9.5000
EUR/SEK	10.4324	10.4000	10.3500	10.3000	10.2500	10.2000	10.1500
EUR/CZK	24.42	24.50	24.50	24.75	24.75	25.00	25.00
EUR/HUF	358.94	360.00	365.00	370.00	375.00	380.00	380.00
EUR/PLN	4.5438	4.5500	4.6000	4.6500	4.7000	4.7500	4.7500

Forecast as of: January 21, 2021

Source: Bloomberg Finance L.P. and Wells Fargo Economics

United States/USD

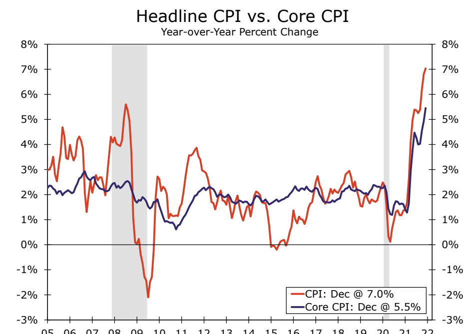
Outlook

Following a brief pause, we expect a trend of U.S. dollar strength to persist through most of 2022 and 2023. After the U.S. dollar gained through late 2021, recent soft data and markets adjusting to the Fed's accelerated tightening plans have seen some greenback consolidation in early 2022. However, once rate hikes begin in March, and the Fed's balance sheet starts shrinking later this year, we expect greenback strength to resume. International central bank tightening that falls short of market expectations could weigh on some G10 currencies, while rising U.S. bond yields could also put downward pressure on emerging currencies.

Fundamental Focus: Economics, Policy & FX

U.S. Growth Slows, U.S. Inflation Quickens

- U.S. economic trends continue to move in opposite directions, including widespread evidence of a slowing in growth momentum late in 2021.
- December nonfarm payrolls rose by just 199,000, less than half the consensus forecast, although the downside surprise was partially offset by upward revisions to prior months. The other details of the report were somewhat firmer, as the jobless rate fell to 4.9% and average hourly earnings rose 0.6% month-over-month.
- December activity data were soft in tone, most notably retail sales, which dropped 1.9% month-over-month, while industrial output also dipped 0.1%.
- December survey data also pointed to some loss of momentum, as the ISM services index fell to 62.0 and the ISM manufacturing index fell 58.7. January consumer sentiment also declined, to 68.8.
- Reflecting this loss of momentum, we have lowered our 2022 GDP forecast, and now anticipate 3.9% GDP growth in 2022.
- In contrast to slower growth, inflation trends have continued to quicken. The December CPI quickened as expected to 7.0% year-over-year, while the core CPI quickened slightly more than expected to 5.5%.



Source: U.S. Department of Labor and Wells Fargo Economics

Elevated Inflation Equals Faster Fed Tightening

- The minutes of December FOMC monetary policy meeting were more hawkish than expected. The minutes noted that given the outlook for the economy, labor market and inflation, earlier or faster interest rate increases might be warranted.
- In addition, some policymakers said it could be appropriate to begin reducing the size of the Federal Reserve's balance sheet relatively soon after beginning interest rate increases.
- Given the hawkish signals, we now forecast four 25 bps rate hikes in 2022, and also expect the Fed to start reducing the size of its balance sheet before the end of this year.

Economic & FX Risks

Upside FX Scenario

- We forecast U.S. dollar strength against most G10 and emerging currencies over our forecast horizon. However, there remains a risk scenario in which the greenback could still appreciate more than we currently anticipate.
- Inflation remains elevated and could recede more slowly than we currently forecast. If so, the Fed could raise rates even more quickly than the four hikes we currently expect for this year—an outcome that should be positive for the U.S. dollar.
- Faster Fed rate hikes, or potentially a more rapid reduction in the size of the Fed's balance sheet, could also push bond yields higher and potentially see equity markets weaken. The latter in particular could offer some safe haven support for the U.S. dollar.

- So far, the Omicron variant appears to be having a moderate impact on activity, although December growth and confidence data were subdued in tone. If the Omicron variant were to have a more severe impact on U.S. growth, that could also weigh on equity markets and provide safe haven support for the greenback.
- Should these scenarios play out, U.S. dollar strength could be of greater magnitude than we currently forecast. We already see U.S. dollar strength lasting until late 2023; however, it is possible under this scenario the U.S. dollar's gains could be larger than we currently forecast.

Central Bank Outlook

Fed Funds Rate Forecast			
Current: 0.125%	**3M**	**6M**	**12M**
Wells Fargo	0.25%-0.50%	0.50%-0.75%	1.00%-1.25%
Market Implied	0.44%	0.70%	1.14%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- In line with the Fed's December announcement, we now expect the central bank to reduce the pace of its bond purchases by $30 billion each month, which would see net bond purchases end by March 2022.
- Given the hawkish Fed minutes, we now expect four Fed rate hikes this year, beginning with a 25 bps rate increase at the March policy meeting. We also forecast three further 25 bps rate hikes in 2023.
- We also expect the Fed to announce in Q3-2022 that it will start shrinking its balance sheet later this year, initially by a moderate $25 billion per month, but with the pace of reduction growing such that it reaches $100 billion per month by the spring of 2023.

Eurozone/EUR

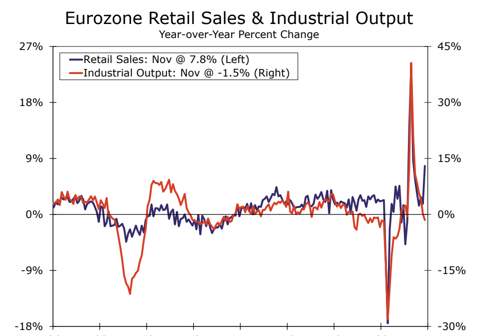
Outlook

While the euro has been relatively resilient early this year, we still expect a weaker currency through 2022 and into 2023. After a solid growth performance earlier in 2021, softer confidence surveys and a rebound in COVID cases point to more subdued growth late last year and early in 2022. There are also hints Eurozone inflation may be close to peaking. Overall, this growth and inflation mix should allow the European Central Bank to taper its bond purchases only gradually. That's a stark contrast to the more accelerated tightening from the Federal Reserve and should, over time, mean a weaker euro against the U.S. dollar.

Fundamental Focus: Economics, Policy & FX

Signs of Slower Eurozone Growth Momentum Late Last Year

- The Eurozone economy enjoyed solid economic growth during Q2-2021 and Q3-2021, but there were signs of slowing momentum as Q4 progressed.
- Economic activity started the quarter on a reasonable note, including solid November retail and industrial data. November retail sales unexpectedly rose 1.0% month-over-month, after having edged higher in October. November industrial output also rose 2.3%, more than reversing the October decline.
- However, as the Omicron variant became more widespread during December, survey data pointed to slower growth. Eurozone December economic confidence fell more than expected to 115.3. Most notably, services confidence fell sharply to 11.2, although industrial confidence improved to 14.9.
- Household income and saving data for Q3-2021 also points to the possibility of ongoing, but slower, growth momentum for the Eurozone economy in 2022. Eurostat reported that Q3 household disposable income rose 0.8% quarter-over-quarter, less than the 1.4% increase in Q2. The household saving rate also fell to 15.0% in Q3 from 19.0% in Q2. Both hint at a somewhat slower pace of consumer recovery in 2022.



Source: Datastream and Wells Fargo Economics

Many ECB Policymakers Still Viewing Inflation Spike as Transitory

- The Eurozone December CPI surprised to the upside, although there were hints that Eurozone inflation is perhaps close to peaking. Headline inflation unexpectedly edged higher to 5.0% year-over-year, while core inflation was steady at 2.6%. Of some note, services inflation actually slowed in December to 2.4%.
- Recent comments from European Central Bank policymakers have been somewhat mixed. On balance however, they still lean toward the spike in inflation being somewhat transitory and also toward a gradual removal of monetary policy accommodation.
- ECB President Lagarde said inflation drivers are expected to ease over the course of this year, ECB policymaker Lane sees inflation falling 2% over the longer term, and policymaker Schnabel recently said the ECB shouldn't raise rates too quickly. Some other policymakers have highlighted some upside risks to inflation.
- Overall, we still view ECB rhetoric as consistent with only a gradual tapering in bond purchases, and steady policy interest rates through 2022 and probably 2023 as well.

Upside FX Scenario

- We forecast a period of extended euro weakness; however, the risks are potentially tilted toward a smaller decline than we currently expect.
- The renewed spread of COVID cases and softening in confidence surveys suggests slower growth in late 2021 and early 2022. However, should Eurozone economy prove more resilient than expected, the euro could prove more resilient as well.
- Eurozone inflation pressures could prove more persistent, and inflation could recede more slowly than we currently forecast. In that scenario, the ECB could end its bond purchases earlier than currently scheduled, and discussions on policy rate hikes sometime in 2023 could also be possible.

A more timely normalization of ECB monetary policy would most likely limit the extent of euro declines.

- This combination of factors should lessen downside pressures for the euro and could limit the decline in the EUR/USD exchange rate to around the $1.1000 level.

Central Bank Outlook

ECB Deposit Rate Forecast			
Current: -0.50%	**3M**	**6M**	**12M**
Wells Fargo	-0.50%	-0.50%	-0.50%
Market Implied	-0.49%	-0.45%	-0.30%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- The ECB announced at its December monetary policy meeting that it will end its PEPP program by March 2022, as scheduled. Upon completion of the PEPP program, we expect the ECB to increase the pace of its regular asset purchase program (APP) to €40B per month for Q2-2022, from €20B per month currently. For Q3-2022, we forecast APP purchases to be conducted at a pace of €30B per month, €20B per month in Q4-2022 and €10B per month in Q1-2023, with quantitative easing coming to an end in March of that year.
- We continue to expect interest rates to remain unchanged for an extended period. We forecast the ECB's Deposit Rate will remain at -0.50% through all of 2022 and 2023.

Japan/JPY

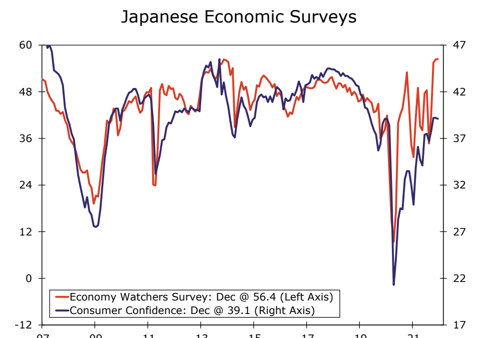
Outlook

We expect a stable yen in the near term and a softer yen over the longer term. Fiscal stimulus has improved prospects for 2022, prompting us to raise our GDP growth forecast, which combined with U.S. dollar consolidation should see a stable yen for now. However, fiscal stimulus will eventually fade and given only modest inflation, the Bank of Japan is playing down any talk of possible rate hikes. Against a backdrop of global monetary tightening and rising global bond yields, that should lead to a softer yen over the longer term.

Fundamental Focus: Economics, Policy & FX

Japan's Economy Firms, Outlook Brightens

- The incoming flow of data points to solid improvement of growth during Q4-2021 as the economy reopened and the state of emergency from earlier last year came to an end.
- November retail sales rose 1.2% month-over-month, on top of an October gain, while the broader measure of November services activity rose 0.4%.
- November industrial output also jumped 7.0% month-over-month, and core private sector machinery orders rose 3.4%.
- Confidence surveys also suggest a solid pace of growth in the period ahead. The December economy watchers survey edged slightly higher to 56.4, while December consumer confidence was broadly steady at 39.1.
- The passage of an additional fiscal stimulus package late last year, totaling a cumulative 10% of GDP, points to a improving outlook for 2022. We forecast Japanese GDP growth of 3.7% for this year.
- In addition to stronger growth, CPI inflation has also moved modestly higher in recent months as the December CPI rose 0.8% year-over-year. That said, much of the price increase has been driven by higher energy prices. The CPI excluding fresh food and energy actually fell 0.7% in December.
- The Bank of Japan held monetary policy steady at its January meeting, including keeping its policy balance rate at -0.10% and the target for 10-year government bond yields are zero percent. Given a relatively moderate uptick in inflation so far, we expect the Bank of Japan to hold monetary policy steady for the foreseeable future. Indeed, Governor Kuroda said there was no debate about a possible rate hike at the January meeting.



Source: Datastream and Wells Fargo Economics

Economic & FX Risks

Upside FX Scenario

- We expect the yen to weaken versus the greenback over the medium term. However, there is a scenario that could see the yen soften less than we currently forecast.
- The reopening of Japan's economy along with fiscal stimulus could see even stronger growth in Japan this year than we currently forecast, an outcome that should be supportive of the yen.
- While not our base case, should inflation continue to surprise to the upside, the Bank of Japan could even begin to hint at policy rate increases, or guide bond yields higher, developments that would also be positive for the yen.
- We currently expect relatively timely monetary policy tightening from the Federal Reserve, including a cumulative 100 bps of rate hikes this year along with a reduction in the size of its balance sheet. Should the Fed fail to fully deliver on those expectations, the yen could benefit.
- In this more favorable scenario for the Japanese currency, the yen could weaken less than we expect, with the USD/JPY exchange rate perhaps reaching JPY118.00-120.00.

Central Bank Outlook

BoJ Policy Rate Forecast			
Current: -0.10%	**3M**	**6M**	**12M**
Wells Fargo	-0.10%	-0.10%	-0.10%
Market Implied	-0.03%	-0.03%	-0.02%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Our outlook is for the Bank of Japan to hold its policy rate steady at -0.10% through all of 2022 and 2023, and to make no major changes to its quantitative easing program. Given the improved 2022 outlook for Japan's economy, we do not expect a further reduction in the Bank of Japan's already negative policy interest rate, though we do not envisage a rate increase for the foreseeable future either.

United Kingdom/GBP

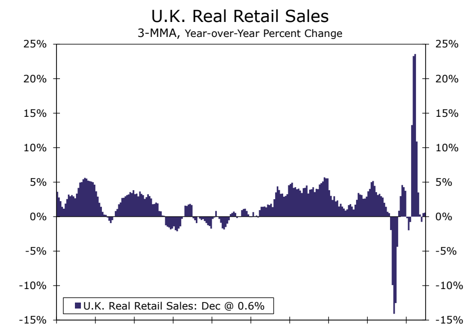
Outlook

Despite a solid start to 2022, we still forecast a weaker U.K. currency as the year progresses. Although inflation remains elevated, the U.K. economy appeared to lose some momentum late last year, given an increase in COVID cases and some softening in confidence surveys. Given what we expect will be an uneven pace of growth, we see only a gradual pace of Bank of England rate hikes, and one that will fall short of the market's tightening expectations. Given the U.K. central bank is likely to under deliver on monetary tightening, and also lag behind Fed tightening, our outlook remains for a softer pound over time.

Fundamental Focus: Economics, Policy & FX

U.K. Growth Set to Stumble From Steady Recent Pace

- The U.K. economy registered solid growth through late 2021, though with the spread of COVID cases from December in particular, a softening in confidence surveys, we see more subdued activity in the months ahead.
- U.K. November GDP rose 0.9% month-over-month, more than twice as much as expected. Services output rose 0.7%, while industrial output rose 1.0%.
- Labor market trends were a little mixed. Employment for the three months to November rose by 60,000 compared to the prior three months, a slowing from the recent pace of gains, although the unemployment rate dipped to 4.1%. An alternative measure of payrolled employees was firmer, rising by 184,000 in December.
- However, retail activity slowed noticeably in December. Retail sales slumped 3.7% month-over-month, a result that came after a December retailers' survey showed a sharp drop in the reported sales balance to +8.
- Meanwhile on the price front, the December CPI quickened more than expected to 5.4% year-over-year, while the core CPI unexpectedly quickened to 4.2%.
- Despite elevated inflation, the prospect of uneven economic growth means we expect only a gradual pace of tightening from the Bank of England. We expect 50 bps of rate hikes this year, well below the approximately 110 bps of rate increases currently anticipated by market participants.



Source: Datastream and Wells Fargo Economics

Economic & FX Risks

Downside FX Scenario

- Our base case is for a softer pound over the next several quarters, in part due to faster Fed tapering and faster Fed rate hikes. However, the risks are likely tilted toward a larger pound decline.
- Growth indicators softened noticeably in December, and the outlook for the next several months is somewhat uncertain, given a rebound in COVID cases. It is possible U.K. growth could surprise to the downside, prompting the Bank of England to raise rates even more gradually than we currently forecast.
- Meanwhile, market expectations remain somewhat aggressive, anticipating twice as much in the way of rate increases in 2022 than we currently forecast. If, as we expect, the Bank of England fails to fully deliver, the recalibration of interest rate expectations should be a negative for the pound.
- In this more pessimistic scenario, the pound could fall toward a $1.2300-$1.2500 range.

Central Bank Outlook

BoE Bank Rate Forecast			
Current: 0.25%	**3M**	**6M**	**12M**
Wells Fargo	0.25%	0.50%	0.75%
Market Implied	0.67%	1.02%	1.37%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- The Bank of England kicked off its rate hike cycle in December with a modest 15 bps policy rate increase to 0.25%.
- In 2022, we see only a gradual pace of monetary tightening and forecast 25 bps rate hikes at the May 2022 and November 2022 announcements. We also expect Bank of England tightening to continue in 2023, with further rate increases slated for that year.

Switzerland/CHF

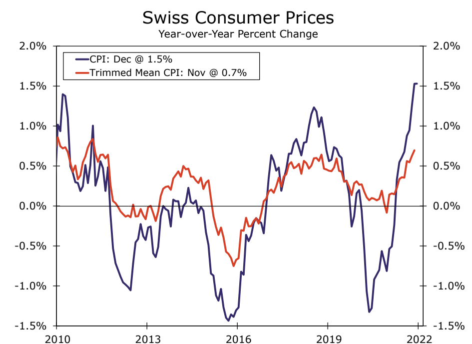
Outlook

We forecast a broadly steady franc versus the euro, and a softer franc versus the U.S. dollar, over the medium term. Recent data point to an ongoing albeit moderate slowing in Swiss growth, meaning that even with a moderate firming of inflation, Swiss National Bank policy interest rates should remain on hold for an extended period. That should limit any gain in the franc versus the euro, even given accommodative ECB monetary policy. The potential for Swiss FX intervention should also see a broadly stable franc versus the euro, but a softer franc versus the greenback, given the euro's overall weakening trend.

Fundamental Focus: Economics, Policy & FX

Switzerland's Economy Steadies After a Slowdown

- The Swiss economy slowed during the latter part of 2021, but there are signs in recent data that growth may now be steadying.
- December survey data showed a slight increase in the manufacturing PMI to 62.7, while the KOF leading indicator saw only a modest decline to 107.0.
- November real retail sales were also solid, firming to 5.8% year-over-year. November real exports rose 1.6% month-over-month, although that was outstripped by a 4.3% increase in real imports.
- Swiss inflation continues to firm, albeit by far less than most other G10 economies. The December CPI was steady at 1.5% year-over-year, while the November trimmed mean CPI firmed slightly to 0.7%.
- Steadying growth and firmer inflation could offer some support to the Swiss franc in the near term. However, we expect any franc gains to be modest at best. For Q3, Swiss National Bank FX intervention amounted to just 2.8B francs. However, there are signs FX intervention activity has increased in recent month, as Swiss FX reserves rose 22.8B francs in December to 945B francs.



Source: Datastream and Wells Fargo Economics

Economic & FX Risks

Upside FX Scenario

- Our outlook is for gradual weakness in the franc versus the euro and U.S. dollar over the medium term; however, there is an upside scenario that could see gains versus the euro and more gradual losses versus the greenback.
- Despite concerns surrounding the Omicron variant, COVID concerns are expected to ease during 2022. That said, should spread of COVID became more worrying than expected and weigh on economic activity and financial markets, the Swiss franc could get a boost from safe haven support.
- We expect the European Central Bank to shift only gradually toward less accommodative monetary policy. Still, given the possibility of downside risks to the Eurozone economy and potentially even more gradual moves from the ECB, there is some potential for the franc to gain further versus the euro.
- In this scenario, the franc could strengthen, with the EUR/CHF exchange rate perhaps falling close to CHF1.0000.

Central Bank Outlook

SNB Policy Rate Forecast			
Current: -0.75%	**3M**	**6M**	**12M**
Wells Fargo	-0.75%	-0.75%	-0.75%
Market Implied	-0.69%	-0.63%	-0.41%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- We expect the Swiss National Bank's policy interest rate to remain steady at -0.75% for all of 2022 and 2023.

Canada/CAD

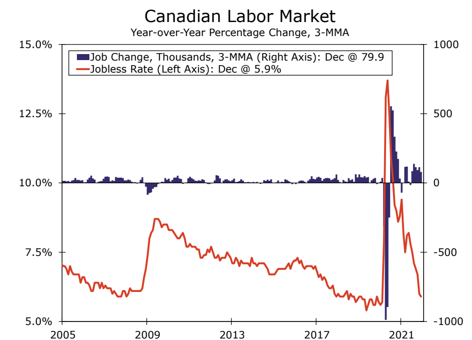
Outlook

We expect moderate weakness in the Canadian dollar through 2022 and into 2023. Canadian economic fundamentals are sound, including a strongly recovering labor market and indications that activity is picking up more broadly as well. With inflation elevated, we expect a steady series of rate hikes next year, though likely still less than what is currently priced in by market participants. Given the prospect of accelerated Fed tightening, we should see some weakness in the Canadian currency over time, even with a reasonably favorable Canadian economic outlook as well as some recent increase in oil prices.

Fundamental Focus: Economics, Policy & FX

Canada's Solid Recovery Continues, But Uncertainties Return in Early 2022

- Canada's economy finished 2021 on a solid note. However, a renewed spread of COVID cases and the reimposition of some restrictions could lead to slower growth during early 2022.
- The labor market continues to enjoy a strong advance, as December employment rose a further 54,700, including a 122,500 increase in full-time employment. The jobless rate also fell to 5.9%.
- Other measures of activity have also been solid in Q4. November retail sales rose 0.7% month-over-month after a sturdy October gain, although the flash estimate is for a decline in sales in December. November manufacturing sales rose 2.6%, while October GDP rose 0.8% month-over-month and firmed to 3.8% year-over-year.
- The Bank of Canada's Business Outlook Survey hinted at slower growth ahead. The Q4 past sales balance surged to +63; however, the future sales balance fell further to +3.
- On the price front, the December CPI edged higher to 4.8% year-over-year, while the average of the core CPI measures also quickened moderately to 2.9% year-over-year.
- Despite elevated inflation, we believe near-term uncertainty will dissuade the Bank of Canada from raising interest rates just yet, and instead anticipate an initial 25 bps rate increase at the central bank's April 2022 meeting.



Source: Datastream and Wells Fargo Economics

Upside FX Scenario

- Our base case is for the Canadian dollar to weaken moderately versus the U.S. dollar in the context of persistent U.S. inflation pressures and faster Fed tapering and rate hikes. However, there is a scenario in which the Canadian dollar could soften by less than we currently forecast.
- A period of Canadian economic softness seems likely in early 2022, given a renewed spread of COVID cases. However, if the economy proves more resilient than anticipated, that could limit the extent of Canadian dollar declines.
- If growth proves resilient and inflation remains elevated, the Bank of Canada could raise rate more quickly than we currently forecast and instead closer to the pace anticipated by market participants, which could also limit Canadian dollar losses.
- Oil prices have firmed a bit in recent weeks, which could offer some support to the Canadian currency.
- In this more favorable scenario, the Canadian dollar could soften less than we expect, with weakness perhaps limited to around a USD/CAD exchange rate of CAD1.2800 over time.

Central Bank Outlook

BoC Overnight Rate Forecast			
Current: 0.25%	**3M**	**6M**	**12M**
Wells Fargo	0.50%	0.75%	1.00%
Market Implied	0.74%	1.16%	1.79%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Our outlook for Canadian monetary policy is unchanged. We expect an initial 25 bps rate hike at the April 2022 meeting, followed by another 25 bps hike in July 2022 and another 25 bps hike in October of next year. With these moves, we forecast the Bank of Canada's policy interest rate to end 2022 at 1.00%.

Australia/AUD

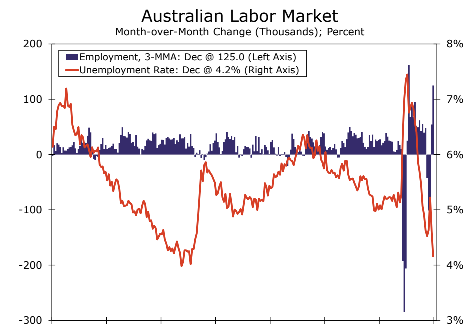
Outlook

We expect the Australian dollar to weaken moderately in the quarters ahead. The economy appears to be rebounding strongly, including gains in employment and consumer spending. That should lead the Reserve Bank of Australia to taper its bond purchases during the first half of this year, and should also lead to earlier rate hikes than previously anticipated—though still not until the start of 2023. That's slower than what is currently priced in by the market and would also lag behind the Federal Reserve, and also given a mixed Chinese economic outlook, should mean moderate losses for the Australian dollar over time.

Fundamental Focus: Economics, Policy & FX

Australian Economic Rebound Continues, Mild Uncertainties Persist

- Recent indicators point to a strong rebound during the fourth quarter as the economy reopened and the government progressively lifted COVID-related restrictions.
- In particular, December employment rose by 64,800, on top of a large 366,100 gain in November. The details of the report were also strong, showing a full-time employment gain of 41,500 in December, while part-time employment rose 23,300. The unemployment fell to 4.2%.
- There was also further evidence of improving consumer activity as November retail sales rose 7.3% month-over-month, twice as much as expected, on top of a 4.9% gain in October.
- These recent economic indicators offer encouragement for the 2022 outlook, although some uncertainties persist, given a sharp rise in COVID cases in recent weeks. To date, the government has not reimposed any significant restrictions in response to the latest surge in cases. However, January consumer confidence did fall 2.0% month-over-month, hinting that consumer caution could potentially be a temporary restraint on economic activity.



Source: Datastream and Wells Fargo Economics

Reserve Bank of Australia to Start Raising Rates by Early 2023

- Given the overall improvement the economy, the market's focus has turned to the path of Australian monetary policy and when the Reserve Bank of Australia (RBA) might next shift monetary policy in a less accommodative direction.
- In that context, the minutes of the RBA December meeting indicated that slowing bond purchases in February and ending bond purchases in May were consistent with its existing forecasts, while also presenting scenarios where bond purchases could be tapered either more quickly or more slowly than this "base case". Given the near-term uncertainties, we believe the RBA will follow the middle course of slowing purchases in February and ending purchases in May.
- However, given the recent strength of the rebound in activity and the prospect of faster inflation in the quarters ahead, we anticipate the RBA could raise interest rates earlier than we previously expected. We now forecast an initial 15 bps hike to 0.25% in February 2023, with additional 25 bps hikes also expected in May, August and November of next year.

Economic & FX Risks

Upside FX Scenario

- Our base case is for a softer Australian dollar over time. However, the risks appear tilted toward a smaller decline than our base case forecast.
- The economy is enjoying a solid rebound, and could prove more resilient than expected even in the face of the latest wave of COVID cases, a scenario that should offer some direct support for the Australian currency.

- A resilient economy could also prompt the Reserve Bank fo Australia to end its bond purchases more quickly, and possibly signal earlier rate increases, both factors that would offer some support for the Australian dollar.
- While not our base case, should Chinese growth respond in a strong positive fashion to policy easing from Chinese authorities, that would likely also be helpful for Australian dollar.
- In this more favorable scenario, the AUD/USD exchange rate could fall only moderately, perhaps not weakening much below the $0.7000 level.

Central Bank Outlook

RBA Cash Rate Forecast			
Current: 0.10%	**3M**	**6M**	**12M**
Wells Fargo	0.10%	0.10%	0.10%
Market Implied	0.25%	0.50%	1.20%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Australia's economy is returning to a steadier growth path. As a result, we expect the next tapering of the RBA's bond purchases to occur in February, at which time we expect the weekly pace of bond purchases to slow to A$2B from the current A$4B. We expect that reduced pace of bond purchases to continue until May 2022, at which time the quantitative easing program will come to an end.
- We expect the RBA to hold its Cash Rate steady at 0.10% through all of 2022. However, we now see rate hikes beginning in early 2023, and expect a 15 bps rate hike in February next year, followed by 25 bps rate hikes in May, August and November.

New Zealand/NZD

Outlook

We expect the New Zealand dollar to soften versus the greenback in the coming quarters, given our expectation for accelerated Fed tightening. As the New Zealand economy reopens and activity rebounds, we anticipate solid growth and higher inflation. Against this backdrop, we expect the Reserve Bank of New Zealand (RBNZ) to continue tightening monetary policy in February and beyond, although less aggressively than what is currently priced into markets, which could contribute to NZ dollar weakness compared to the U.S. dollar.

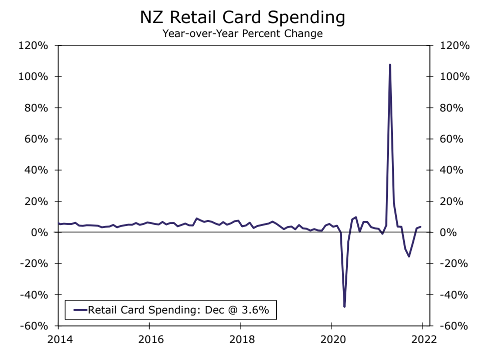
Fundamental Focus: Economics, Policy & FX

New Zealand Economy Supported by Consumers Amid Gradual Reopening

- Recent data indicate that economic activity has held up as the economy continues to gradually reopen after its lockdown.
- Consumer spending been supportive of growth over the past few months. Credit card spending increased 4.5% month-over-month in November, and October's figure was revised to show a 9.3% increase, from 8.4% previously. December retail card spending rose 0.4% month-over-month on top of surging 9.5% and 10.3% the prior two months. Total card spending rose 1.9% month-over-month—driven by a 16.6% gain in services spending. While both card spending gains were relatively small compared to previous months', they show that Omicron fears have not had a severe impact on activity as of yet.
- While consumer spending has been resilient, the Omicron variant does add some uncertainties to the outlook, as New Zealand delayed its border reopening to the end of February from the middle of January. In addition, managed isolation quarantine (MIQ) facilities have been under some pressure from overseas travelers coming into the country, and the release of new MIQ rooms has been postponed temporarily due to a rise in cases. However, the spread of COVID within the New Zealand community has receded, and currently 93% of the country's eligible population is fully vaccinated.
- Importantly, the government has indicated that it will not use lockdowns again to defend against the Omicron variant. Prime Minister Ardern has said, "We won't be able to stop omicron entering the community, but we can use tools to try and slow it down", a change in strategy compared to previous waves of COVID.
- Despite this, consumers have a positive outlook for the economy, as December consumer confidence increased for the first month since June—rising 1.80% month-over-month after a 1.40% decrease in November.
- Finally, New Zealand's food price index rose 4.5% year-over-year in December—the most in over 10 years—suggesting that inflation may be heating up. Food comprises about one-fifth of the consumer price index, which will be a key data release ahead of the RBNZ's February meeting.

Reserve Bank of New Zealand Signals Future Rate Hikes

- The RBNZ last raised rates at its November meeting by 25 bps to 0.75%. The central bank signaled that future rate hikes would come in 25 bps steps, citing above-target headline inflation and a tight labor market.
- The central bank has previously indicated that it is keeping its eye on inflation expectations, which will be a major determinant of the pace of future rate hikes. In its most recent Monetary Policy Statement, it raised its inflation forecast to 5.7% year-over-year in both Q4-2021 and Q1-2022, before it sees inflation gradually easing back down to 2% in late 2024.
- Overall, solid consumer spending and positive consumer confidence data, as well as rising price pressures, suggest that the RBNZ is still on track to increase its policy rate in February.



Source: Datastream and Wells Fargo Economics

Economic & FX Risks

Downside FX Scenario

- As we forecast sustained U.S. dollar strength in the coming quarters, we also expect a softer NZ dollar over the medium term, though the risks are potentially tilted toward a weaker currency than we currently anticipate.
- If the Omicron variant further slows the reopening process and dampens economic activity more than expected, this could weigh on the NZ dollar.
- The currency could face additional downward pressure if the RBNZ does not increase rates by as much as market participants expect.
- In this less favorable scenario, the NZ dollar could fall below $0.6000 in the coming quarters.

Central Bank Outlook

RBNZ Official Cash Rate Forecast			
Current: 0.75%	**3M**	**6M**	**12M**
Wells Fargo	1.25%	1.50%	2.00%
Market Implied	1.20%	1.74%	2.37%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Following the RBNZ's 25 bps rate hike last November, we expect another 25 bps rate increase at its February 23 meeting, which would bring the Official Cash Rate to 1.00%.
- We anticipate 125 bps of rate hikes in 2022, which would see the Official Cash Rate finish this year at 2.00%. Our projected pace of monetary tightening is slightly slower than what is currently priced into markets.

Sweden/SEK

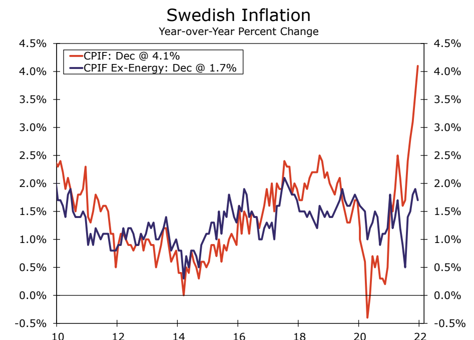
Outlook

We expect modest gains in the Swedish krona versus the euro over the medium term, but weakness versus the greenback. Sweden's economy has rebounded from a brief summer pause, which should provide some modest support for the krona. Moreover, given the ongoing recovery, the central bank has begun to signal an eventual shift to less accommodative monetary policy, also a krona positive. Together, these factors should see the krona gain modestly versus the euro, but likely fall versus the greenback, given the prospect of faster Fed tightening.

Fundamental Focus: Economics, Policy & FX

Swedish Growth Solid, Underlying Inflation Subdued

- Sweden's economy continued to show solid momentum late in 2021, though a brief soft patch may be possible early this year as the government reimposed some limited restrictions in the wake of an uptick in COVID cases.
- The November GDP indicator rose 0.2% month-over-month after a large 1.3% gain in October, and firmed to 5.4% year-over-year. November household consumption was strong, rising 1.0% month-over-month.
- With respect to private sector activity, private sector production eased to 6.5% year-over-year, as growth in services production firmed slightly to 8.2%, while growth in industry production eased to 4.2%.
- While December survey data were softer, they still point to reasonable momentum last month. The December manufacturing PMI fell to 62.1, while the services PMI fell to a still-elevated 67.3. December economic confidence also eased to 117.1, as consumer confidence fell but manufacturing confidence rose.
- While overall inflation quickened in December, underlying price pressures remain relatively subdued. CPIF inflation firmed to 4.1% year-over-year, but CPIF inflation excluding energy eased back to 1.7%. Those subdued underlying price trends should see the central bank hold interest rates steady through most, if not all, of 2022 and 2023.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Central Bank Outlook

Riksbank Interest Rate Forecast			
Current: 0.00%	**3M**	**6M**	**12M**
Wells Fargo	0.00%	0.00%	0.00%
Market Implied	0.06%	0.14%	0.38%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Our outlook for Swedish monetary policy remains unchanged. We expect the Riksbank to hold its policy rate steady for an extended period and see the repo rate remaining steady at 0.00% through all of 2022 and 2023.

Norway/NOK

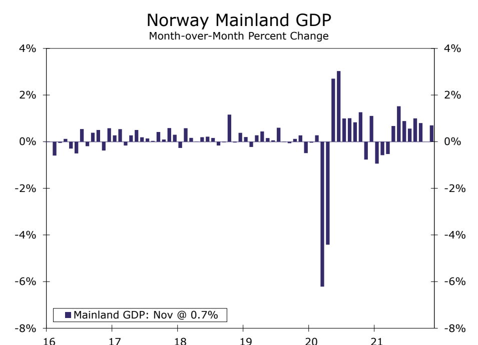
Outlook

We expect a stronger Norwegian krone versus the euro, but some weakness versus the U.S. dollar. While Norway's economic recovery continues, mixed recent data hint at some moderation in the pace of expansion in recent months. In contrast, inflation has started to firm modestly, meaning we still see the Norges Bank on course to raise rates in March and multiple times during 2022. A recent rise in oil prices should also be supportive of the krone, which we expect will gain versus the euro, given easy ECB policy, although we do anticipate some weakness in the krone versus the greenback.

Fundamental Focus: Economics, Policy & FX

Norway's Monetary Tightening to Continue Despite Mixed Data

- The latest economic figures from Norway are somewhat mixed, but still likely leave the central bank on course to raise interest rates further at its March monetary policy meeting.
- November mainland GDP rose 0.7% month-over-month, the seventh gain in the past eight months. November retail sales were also firm, rising 0.9%.
- The news from the industrial sector was softer in tone. November manufacturing output was flat for the month, while industrial output fell 3.0% month-over-month. The December manufacturing PMI also declined to 58.0.
- While activity trends were mixed, inflation moved higher in December. The headline CPI quickened to 5.3% year-over-year, while the underlying CPI quickened more than forecast, to 1.8% year-over-year.
- Signs of firmer inflation should keep the central bank to raise interest rates again in March. Indeed, the Norges Bank held its policy rate steady at 0.50% at this week's monetary policy meeting, but signaled that interest rates would most likely be raised again at its meeting in March.
- Finally, the recent rise in oil prices should also offer some support to petroleum sector activity, as well as improving sentiment towards the Norwegian currency.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Central Bank Outlook

Norges Bank Deposit Rate Forecast			
Current: 0.50%	**3M**	**6M**	**12M**
Wells Fargo	0.75%	1.00%	1.25%
Market Implied	0.69%	0.91%	1.37%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

- The Norges Bank held its policy rate steady at 0.50% this month, as expected. However, we expect a relatively steady pace of rate increases in 2022, and forecast a 25 bps rate increase in each of Q1, Q2 and Q3 of this year.

Mexico/MXN

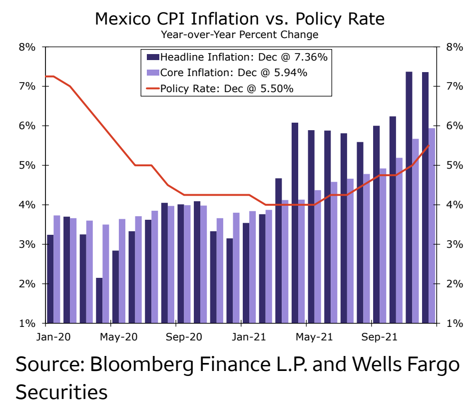
Outlook

Through Q1-2022, we expect a stable Mexican peso; however, over the longer term, we expect the currency to weaken amid aggressive Fed tightening and as capital flows return to dollar-denominated assets. The Mexican economy has shown signs of softening, but despite a decelerating economy, we expect the Central Bank of Mexico to continue raising interest rates. To that point, we expect Banxico to lift its Overnight Rate another 50 bps in February under the leadership of new central bank Governor Rodriguez.

Fundamental Focus: Economics, Policy & FX

Fed Picking Up the Tightening Pace

- FOMC minutes reveal the Fed is shifting to an even more hawkish stance on monetary policy. Given the guidance markets have received, we now expect the Fed to raise interest rates four times this year (up from two previously). In addition, our U.S. economics team also expects the Fed to begin shrinking its balance sheet in H2-2022, an additional form of tightening. While markets may be going through a "buy the rumor, sell the fact" period right now, we expect this aggressive Fed tightening to place pressure on the Mexican peso over time.
- In addition, aggressive Fed tightening should result in a slower pace of global growth and restrain the overall economic recovery. We have consistently revised our global GDP forecast lower, and as the global economic recovery moderates even further, emerging market currencies should weaken amid a flight to safe havens such as the U.S. dollar. As this materializes, the Mexican peso should weaken over the remainder of 2022 and into 2023.



Source: Bloomberg Finance L.P. and Wells Fargo Securities

Rodriguez Sticking to the Script

- This year, Victoria Rodriguez will take over as governor of the Central Bank of Mexico. While the peso sold off sharply in response to the appointment of Rodriguez, concerns regarding her independence have since abated. Rodriguez has little experience setting monetary policy; however, Mexico has strong institutions, and we do not believe the independence of the central bank is reduced with Rodriguez being appointed.
- Local inflation remains elevated and well above the central bank's 4% target. In December, the headline CPI rose 7.36% year-over-year, while core inflation climbed closer to 6%. With inflation still above target and markets somewhat fragile, we doubt Rodriguez will look to rock the boat too much. In that sense, we expect another 50 bps rate hike at Banxico's meeting in February.
- Forward guidance will be key to determine the future path of rate hikes. We expect policymakers to note that inflation is still elevated and the price formation process still concerning. We would also not be surprised if policymakers refer to the Fed's earlier and more aggressive timeline for removing policy accommodation. Against that backdrop, we expect Banxico to maintain its stance on monetary policy and continue lifting the Overnight Rate over the course of 2022.
- A 50 bps February rate hike is currently priced into the peso; however, we could still see volatility in the currency in the aftermath of the meeting should guidance be on the dovish side. Banxico board members turned over this year, and in our view, in a modestly dovish direction. Should the new board indeed suggest a less hawkish outlook for rates, the peso could experience a selloff and the longer-term depreciation we expect could materialize early.

Economic & FX Risks

Downside FX Scenario

- Risks around our peso forecasts are tilted to the downside, as emerging market currencies could come under more pressure than we expect amid Fed tightening. The aggressive nature of Fed tightening could result in a "taper tantrum" scenario where emerging market currencies come

under extreme pressure. Should another "taper tantrum" situation materialize, the peso could experience a sharp selloff and USD/MXN could test MXN24.50.

Upside FX Scenario

- An upside scenario is also centered on Fed monetary policy. For now, we forecast peso weakness throughout 2022 and into 2023; however, the peso could strengthen if the Fed is successful at tightening policy in a way as to not disrupt the global economic recovery. Should the global recovery remain intact and sentiment remain positive, the peso could continue its recent rally.
- In this scenario, the peso could reach MXN19.50 toward the end of 2022 and hold those gains into 2023.

Central Bank Outlook

Banxico Overnight Rate Forecast			
Current: 5.50%	**3M**	**6M**	**12M**
Wells Fargo	6.25%	6.75%	7.50%
Market Implied	6.31%	6.95%	7.66%

Source: Bloomberg Finance L.P. and Wells Fargo Economics

China/CNY & CNH

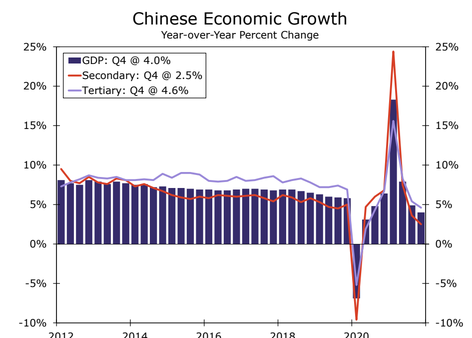
Outlook

In the short term, we forecast modest renminbi strength as foreign currency sentiment remains supported; however, over the medium to longer term, we expect the Chinese currency to gradually depreciate. Policymakers have eased monetary policy this year and seem committed to further policy support to stabilize China's economy. Given the diverging paths for monetary policy in the U.S. and China, we believe rate differentials could place depreciation pressure on the renminbi and result in a weaker currency over time.

Fundamental Focus: Economics, Policy & FX

Policy Easing Gathering Momentum

- Q4-2021 GDP data surprised to the upside, as the economy grew 1.6% quarter-over-quarter. We forecast quarterly growth of 1.5%, and given the upside surprise, China's economy grew more than we expected at 8.1%. Annual growth of 8.1% is the fastest pace of growth in China for some time; however, the majority of this growth was due to base effects. Despite the strong annual growth rate, we remain concerned with China's economy especially as authorities remain committed to their "zero COVID" policy.
- In an effort to support the economy, the People's Bank of China (PBoC) has eased monetary policy. Reserve Requirement Ratios have come down, while the seven-day reverse repurchase rate and other lending rates have been lowered. In addition, we expect fiscal policy to turn more expansionary over the course of this year. As far as the direction of policy, Chinese monetary and fiscal policy is diverging from the direction of policy in the United States.
- In our view, diverging paths for policy between China and the United States should place depreciation pressure on the Chinese renminbi over time. We expect further reductions to the Reserve Requirement Ratio as well as other lending rates, and for sovereign yields in China to continue moving lower. As yield differentials compress, the renminbi, in our view, should weaken.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Commitment to COVID-Zero

- Throughout the COVID crisis, China has been steadfast in setting restrictions to protect against the spread the virus. Mass testing, border restrictions and lockdowns have been protocol for close to two years now, and the economy has suffered as a result. China is currently experiencing another wave of infections and has locked down some of the more heavily populated areas of the country.
- These mobility restrictions and lack of economic activity should weigh on the economy in Q1-2022. To that point, we revised our Q1 GDP forecast lower and also revised our 2022 annual GDP forecast lower. We now forecast China's economy to grow 5.1% this year, down from 5.5% last month.
- In addition to COVID-related disruptions, China's property sector remains under pressure. Additional property developers have flagged default risks, while home sales and other real estate data have deteriorated. We expect China's real estate sector to act as a drag on the economy for the foreseeable future, and could potentially make additional downward adjustments to our GDP forecast should the real estate sector worsen.

Economic & FX Risks

Downside FX Scenario

- Risks around our renminbi forecasts are tilted toward a weaker currency than we forecast. It is possible that, in the short term, the PBoC will seek to intervene and artificially weaken the currency to support exports and the broader Chinese economy. While we do not expect a full-blown devaluation, we also cannot rule out the possibility.
- The risk of escalating geopolitical tensions between the U.S. and China in 2022 is also a downside risk for the renminbi. President Biden is still pursuing a coordinated approach against China, while

China's perceived aggression toward Taiwan could also lead to a strained relationship between the U.S. and China. Should geopolitical tensions escalate further, the renminbi would likely come under more long-term pressure.

- Should any or all of these risks materialize, the PBoC could allow the renminbi to depreciate significantly and capital flows could exit China. This combination could result in significant renminbi weakness, in which USD/CNY and USD/CNH could test CNY/CNH7.00.

Brazil/BRL

Outlook

The Brazilian real has rallied to start the year; however, we believe the real's outperformance will be short-lived and forecast a weaker currency over the course of 2022 and into 2023. Our concerns are tied to this year's Presidential election and the potential for Brazil's debt and fiscal dynamics to deteriorate ahead of and after the election. We are also worried about the Brazilian economy sliding deeper into recession and for deteriorating economic prospects to hurt sentiment toward the currency.

Fundamental Focus: Economics, Policy & FX

Brazil's Economy to Decelerate Further

- Currently, Brazil's economy is in technical recession. Activity has been weighed down by one of the more aggressive monetary tightening cycles in the world and plagued by elevated inflation as well as weather-related disasters. In our view, the Brazilian economy is likely to remain sluggish and in and out of recession over the course of 2022. To that point, we revised our GDP forecast lower and now expect the economy to grow just 0.7% this year.
- Many of the dynamics that weighed on Brazil's economy last year are likely to persist this year. We expect the Brazilian Central Bank to keep raising interest rates for the next few quarters, and while inflation may trend lower, price growth will remain elevated. Tighter monetary policy and high inflation should keep consumer activity somewhat muted, and the broader Brazilian economy from gathering any significant momentum.
- However, there is also upside risk to the economy as we expect President Bolsonaro to attempt additional fiscal stimulus ahead of this year's Presidential election. Bolsonaro has been successful at extending and enhancing social spending programs, and as his approval ratings remain low and he falls further behind in opinion polls, he could propose new stimulus efforts.
- Should Bolsonaro pursue new fiscal stimulus, financial markets would likely react unfavorably to the prospect of Brazil's fiscal balance turning more negative and the government debt burden rising. Should the spending cap also be evaded and disregarded, markets would likely sell off even more than we expect.

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Political Risk Should Spark Weaker BRL

- We expect the lead-up to Brazil's Presidential election to be contentious and rattle financial markets. Right now, President Bolsonaro is well behind in polls, while former President Lula da Silva is the frontrunner to take office. As mentioned, our concerns stem from Bolsonaro pursuing additional social spending ahead of the election. Markets may also be concerned with a Lula presidency; however, recent action and commentary from Lula have been seen as encouraging.
- Recently, Lula expressed a desire to have former Sao Paulo Governor Geraldo Alckmin become his running mate and Vice President. Lula's invitation to Alckmin resulted in a BRL rally as Alckmin is viewed by financial markets as a fiscally prudent and orthodox policymaker. Alckmin could be a force to promote fiscal stability, which if achieved, could pave the way for more encouraging budget and debt dynamics.
- As campaigning intensifies and policy platforms are revealed, we expect the Brazilian real to selloff. Local political risk should weigh on the real, while we also expect Fed tightening to contribute a weaker currency.

Economic & FX Risks

Downside FX Scenario

- Monetary policy dynamics are somewhat encouraging; however, we doubt tighter monetary policy will be enough to offset political and fiscal risks. Should fiscal and debt dynamics worsen, and should the spending cap be breached, the currency would likely face significant depreciation

pressure. Our targets for the USD/BRL exchange rate would likely be reached earlier than we anticipate.

- In a scenario where Brazil's spending cap does get breached, the USD/BRL exchange rate would likely reach record levels, possibly as high as BRL7.00 per dollar.

Upside FX Scenario

- A scenario for a stronger Brazilian real includes a solid commitment to fiscally prudent policy and the constitutional spending cap. Despite falling approval ratings, Bolsonaro would need to push back against any additional fiscal stimulus for the currency to rally materially, while Lula would need to continue suggesting fiscal responsibility.
- Spending restraints could lead to capital flows returning to Brazil and support the currency. In addition, should Bolsonaro retain office, a longer-term relief rally for the currency is possible, especially if markets do not question the spending cap or believe Brazil has a plan to put public finances on a more stable trajectory.
- In this scenario, USD/BRL could move below BRL5.00 and would likely sustain gains over the course of 2023.

Central Bank Outlook

BCB Selic Rate Forecast			
Current: 9.25%	**3M**	**6M**	**12M**
Wells Fargo	10.75%	11.75%	11.25%
Market Implied	12.41%	12.49%	12.11%

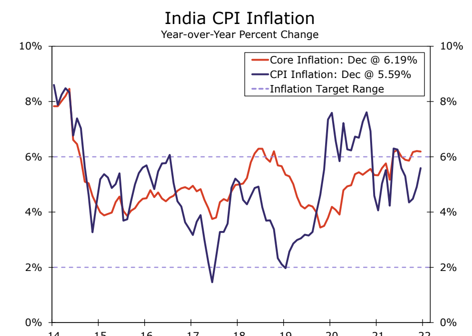
Source: Bloomberg Finance L.P. and Wells Fargo Economics

- Our view on Brazilian policy rates is unchanged. We still expect a 150 bps rate hike in February 2022, consistent with BCB guidance. Over the course of 2022, we expect the BCB tightening cycle to bring the Selic rate to 11.75%. By the end of 2022, we expect the BCB to begin unwinding rate hikes consistent with its baseline scenario for the economy.
- In our view, financial markets are still priced for the Selic rate to be lifted too aggressively. As financial markets adjust to less aggressive hikes and also rate cuts by the end of 2022, monetary policy divergences could also contribute to a weaker Brazilian currency over the longer term.

Asia

India/INR

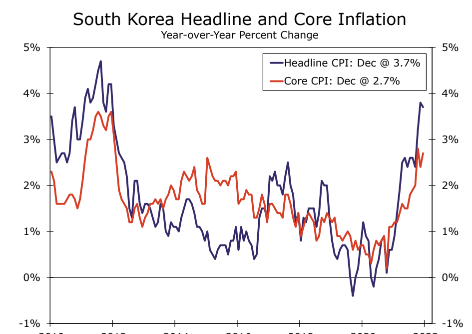
Outlook: India is currently experiencing a third wave of COVID infections lead by the Omicron variant, and early evidence suggests the renewed spread of the virus may be having a negative impact on economic activity. With that said, we do not expect another full-scale lockdown, and believe the economic effects of the current wave will be somewhat mild and rather short-lived. We do, however, expect inflationary pressures to build, and for core inflation to move above the upper bound of the Reserve Bank of India's target range in the near future. As underlying inflation rises above the RBI's target range, we expect the central bank to turn more hawkish. To that point, we now expect policymakers to begin raising interest rates in Q1-2022 and to steadily tighten monetary policy over the course of this year. Despite tighter monetary policy, we continue to believe the Indian rupee will weaken over the long term. Fed tightening should contribute to a weaker rupee; however, we expect depreciation to be gradual as the RBI would likely use its large stockpile of FX reserves to mitigate rupee volatility. As the Fed lifts interest rates and eventually shrinks its balance sheet, the U.S. dollar should broadly strengthen against most emerging market currencies, including the Indian rupee.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

South Korea/KRW

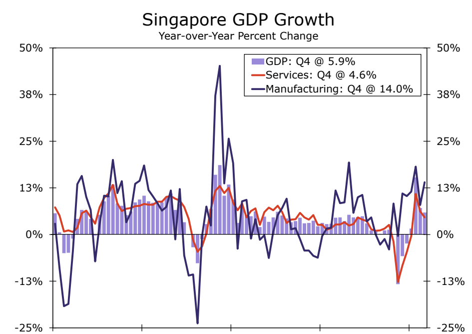
Outlook: We expect a stable Korean won in the short term; however, the longer-term prospects are less positive, and we expect modest depreciation over the remainder of 2022 and into 2023. Through Q1-2022, we expect sentiment toward foreign currencies to generally remain supported and keep the won steady. However, as the Fed adjusts policy settings over the remainder of the year, we expect U.S. dollar strength to resume and for the won to weaken. In addition to the Fed, as China's economy slows and the renminbi weakens over the course of 2022, sentiment toward emerging Asian currencies could also sour and the won could soften. As far as the Korea's economy, inflation pressures continue to build. Headline inflation has reached 3.7% year-over-year, levels last seen in 2011-2012, while core inflation continues to trend toward 3%. With inflation spiking, the Bank of Korea (BOK) has turned more hawkish and has provided guidance it is prepared to act to tame inflationary pressures if needed. This year, the Bank of Korea raised interest rates another 25 bps, taking its seven-day repurchase rate to 1.25%. While we expect interest rates to trend higher, we expect the pace of tightening to be rather gradual. In our view, higher interest rates and an improving economy can limit volatility in the Korean won; however, Fed tightening, a decelerating Chinese economy and still mixed global activity should be more influential over the path of the won and keep the currency on the back foot.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Singapore/SGD

Outlook: Over the course of 2022 and into 2023, we forecast a modestly weaker Singapore dollar. Our concerns over the health of the global economy have not fully abated, and we have revised our global GDP forecast lower over the past few quarters. Given Singapore's status as a major exporter, we expect a slowdown in global economic activity and global demand to place downward pressure on the local economy as well as depreciation pressure on the currency. To that point, Singapore's economy slowed and grew just 5.9% year-over-year in Q4-2021. In addition, we expect the Fed to tighten monetary policy rather aggressively this year, which should broadly support the U.S. dollar and also contribute to a weaker Singapore dollar. With that said, we expect any weakness to be rather gradual as the Singapore dollar is among the less volatile emerging market currencies. Downside risks to our Singapore dollar exchange rate forecasts exist, as Singapore is also heavily reliant upon and linked to China's economy and asset prices. Should China's economy decelerate sharply and local financial markets come under renewed pressure, Singapore's economy and currency are vulnerable and could selloff more than we currently expect.

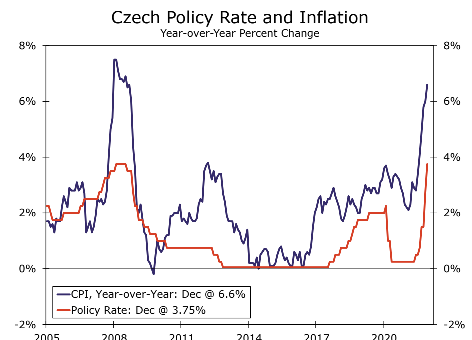


Source: Bloomberg Finance L.P. and Wells Fargo Economics

Emerging Europe, Middle East & Africa

Czech Republic/CZK

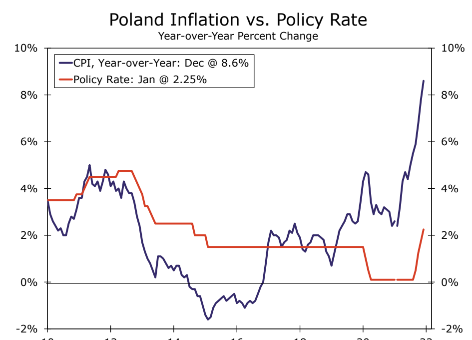
Outlook: In our previous update, we highlighted how Czech inflation jumped at the quickest pace since the global financial crisis. According to the most recent price data, those inflationary pressures have not abated and local inflation has climbed higher. In December, headline CPI jumped to 6.6% year-over-year, another significant move up from the prior month. Higher energy prices and food costs are the culprits for elevated inflation and also the key drivers of the Czech National Bank turning more hawkish. In our view, Czech policymakers have become among the most hawkish in the emerging markets. To that point, in late December, Czech policymakers raised the Repurchase Rate 100 bps to 3.75%, while financial markets were only priced for 75 bps of tightening. In our view, the central bank is likely to maintain this hawkish stance and continue to tighten monetary policy going forward until inflation begins to trend lower. But, despite this hawkish stance, we expect a weaker currency over time. Going forward, we expect broad U.S. dollar strength to outweigh a hawkish Czech central bank and for the koruna to weaken against the dollar over the next few quarters and remain relatively flat against the euro.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Poland/PLN

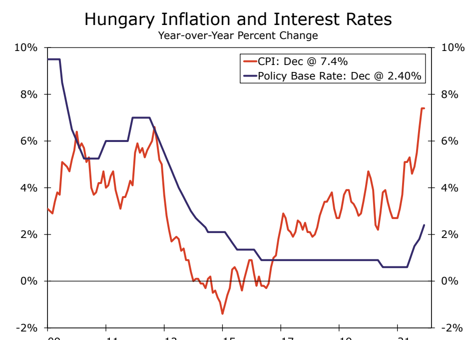
Outlook: We expect the Polish zloty to follow the path of other regional currencies for the time being, and forecast stability against the euro and U.S. dollar in Q1-2022, followed by eventual weakness over the longer term. Poland is currently managing through an inflation shock as the CPI rose 8.6% year-over-year in December. Inflation is currently the highest on record since the early 2000s, and according to local policymakers, price growth is expected to trend higher for at least the next few months. In response to higher inflation, National Bank of Poland (NBP) policymakers have turned more hawkish on their monetary policy stance. Just this year, they lifted the main policy rate 50 bps to 2.25%, while also suggesting similar sized rate hikes are likely going forward. To that point, NBP Governor Glapinski noted after the January meeting that interest rates are set to rise to at least 3%, possibly 4%, by the end of the NBP's tightening cycle. Glapinski also noted that rate hikes are likely to be at 50 bps clips and that establishing positive real interest rates is not a requirement. In our view, interest rates are more likely to move closer to 4% than 3% by the end of this year; however, we expect Fed tightening to be more influential over the path of the zloty. The sharp turn in policy guidance from the Fed should result in a stronger U.S. dollar over the longer term and place depreciation pressure on the zloty.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Hungary/HUF

Outlook: In the short term, we expect the Hungarian forint to stay stable against the euro as well as the U.S. dollar; however, after a brief period of stability we expect the forint to weaken. Year to date, the forint is one of the top performing emerging market currencies as the Hungarian National Bank (MNB) maintains its hawkish policy stance. To that point, MNB policymakers have continued to suggest they will tighten monetary policy this year as inflation rises to levels not seen in decades. Come late January, we expect MNB policymakers to lift the Base Rate again, and for forward guidance to suggest additional rate hikes later in the year, and possibly into 2023. A brief period of dollar stability and tighter MNB monetary policy should stabilize the forint through Q1-2022. Over the medium to longer term we expect depreciation pressure to build again on the currency as Fed monetary policy results in a stronger U.S. dollar. With the Fed now likely to raise interest rates four times this year and begin reducing its balance sheet, the U.S. dollar should gather momentum and strengthen over the course of this year. In addition to Fed monetary policy, there is the risk regional tensions spillover and weigh on the forint as well. The Eastern European migrant crisis rattled local markets late last year, and with similar tensions likely to stem from migrant flows, tensions could build once again. In addition, Russia-Ukraine tensions could also boil over onto Hungarian markets and place depreciation pressure on the currency. At this time, we are not making any explicit forecasts regarding regional geopolitical developments; however, we highlight them as a potential downside risk to our forint forecasts.

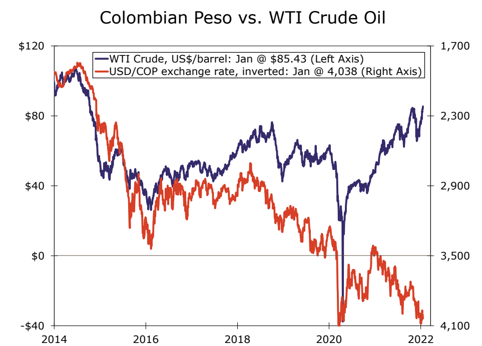


Source: Bloomberg Finance L.P and Wells Fargo Economics

Latin America

Colombia/COP

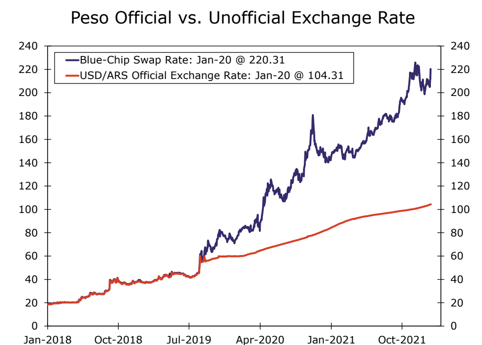
Outlook: Our outlook on the Colombian peso has not changed, and we continue to believe the currency can weaken throughout our entire forecast horizon. Fed tightening is likely to place short to medium term pressure on the currency; however, we believe risks tied to this year's Presidential election should be the main source of depreciation for the peso. As far as the timeline, legislative elections will be held on March 13 and will determine the makeup of Congress. Also on March 13, Colombia will host interparty consultations, essentially primary elections, to determine which candidates will represent each side of the political spectrum in the Presidential election. The outcome of Congressional elections could be a strong indicator for how the general population votes in the Presidential election, and as of now, the left-leaning anti-establishment Gustavo Petro is the leading candidate to take office. Opinion polls suggest Petro has strong support for his populist and progressive policy platform. With Petro leading in polls, local financial markets have become more sensitive to Petro's commentary and suggested policies. To that point, Petro recently suggested he would look to move Colombia's economy away from oil exploration and production. Fossil fuels represent around half of Colombia's total exports, meaning a move away from energy production would be a significant shock to Colombia's economy. Local financial markets sold off on Petro's comments, and going forward, we expect similar rhetoric to rattle the Colombian peso. The actual election will take place in May, with the possibility of a runoff in June, so we expect the peso to come under pressure over the next 5-6 months. Should Petro win the election and have Congressional support for his platform, we would expect the peso to sell off more than we currently forecast.



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Argentina/ARS

Outlook: We continue to believe the Argentine peso will gradually weaken over the entire forecast horizon; however, we now expect a slightly more rapid pace of depreciation. While strict capital controls remain in place, the central bank has allowed for more currency weakness lately. In our view, with FX reserves dwindling and inflation still elevated, the central bank is running out of buffers to halt peso depreciation, and will continue to allow more weakness in the currency. In fairness, the central bank did lift the LELIQ rate 200 bps to 40% in early January; however, we doubt interest rate hikes will be enough to change sentiment toward the currency and disrupt peso depreciation. Headlines related to Argentina are predominantly focused on engagement with the IMF and receiving a new deal to stabilize the economy. As of now, the Argentine government owes $40B to the IMF and will need to start repaying debts in March. According to economy minister Guzman, and acknowledged by IMF officials, Argentina cannot make these payments and will need to negotiate a new plan. In our view, Argentina is likely to receive a new deal; however, a meaningful economic recovery could take years to materialize. Embedded in the plan is likely to be terms outlining fiscal prudence and how to reduce Argentina's debt burden. Also, a new plan could call for liberalizing the exchange rate and lifting capital controls. Should capital controls be lifted, the official exchange rate could selloff significantly and reach the unofficial peso-for-dollars exchange rate.



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