Brown Brothers Harriman

FOREIGN EXCHANGE

OUTLOOK FOR FIRST QUARTER 2023

What Will Steer Rates in 2023?

FOREIGNEXCHANGE

All data and statistics cited are sourced from Bloomberg, January 2023 unless otherwise noted.

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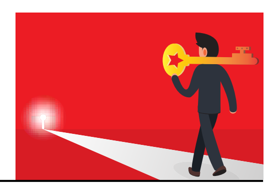
CONTENTS

Two Key Market Themes Will be Tested

As 2023 begins, markets have latched on to two key themes: the Fed pivot and China's reopening. Both have helped risk sentiment improve after the doom and gloom that pervaded global markets in 2022, and we believe they will both dominate trading in early 2023. As the year progresses, we think markets will come to the realization that this optimism had been overdone. In the majors section, we focus on the Fed narrative. China will be discussed in the EM section.



MAJOR MARKETS GLOBAL OVERVIEW

What does the Fed pivot spell for major markets?

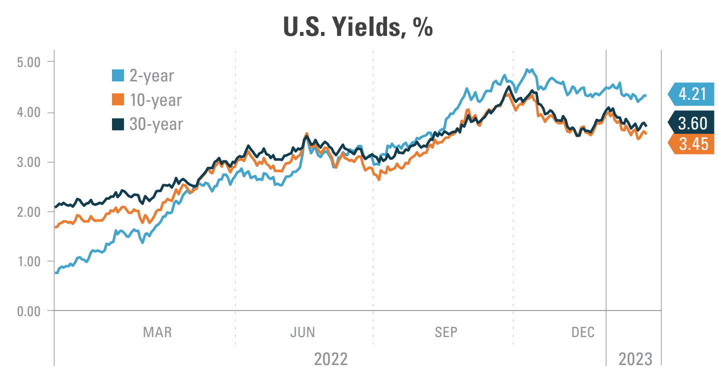
Understanding the likely impact of the current narrative

The Fed Remains the Key Driver

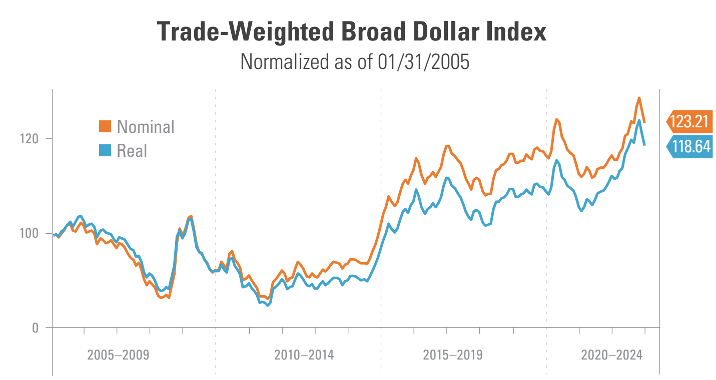
Expectations for Fed policy continue to drive global bond, equity, and FX markets. That is why we think it is crucial to get the Fed call right, as everything else should fall into place. Despite the recent shift in market expectations, our Fed call remains unchanged: we are not yet nearing the end of the tightening cycle, nor is the Fed anywhere close to an easing cycle. As things stand, we believe the U.S. economy remains too resilient for the Fed to consider a shift in policy. Despite recent layoffs in the tech and finance sectors, the labor market remains overall robust while GDP growth ran at an impressive 2.9% seasonally adjusted annual rate (SAAR) in Q4 2022. The Fed is looking at the unemployment rate at the cycle low along with two back-to-back quarters of above trend growth. This means the Fed is likely to have to go higher for longer with rates.

Key Investment Calls

If our Fed call is correct, U.S. rates at the short end should move higher from current depressed levels. The swaps market is pricing in a terminal Fed Funds rate near 5.0%[1] but with inflation and wage pressures likely to prove persistent and broad-based, we see upside risks to this number. That means the short end of the U.S. curve is likely to rise further from current depressed levels. What about the long end of the U.S. curve? This is a much tougher call as the U.S. yield curve remains deeply inverted in anticipation of a recession. That said, we think the recent move below 3.5% was unwarranted and so the 10-year yield should move back and remain in the 3.5-4.0% range in the coming weeks.



The U.S. dollar should eventually resume its climb. We believe monetary policy divergences remain the major driver across FX markets. Within this context, the Fed stands head and shoulders above the others as the most hawkish. However, Powell's performance at the February 1 FOMC decision left much to be desired and its commitment to tighter monetary policy is now much more doubtful. Until the Fed narrative changes for the markets, the dollar remains vulnerable.

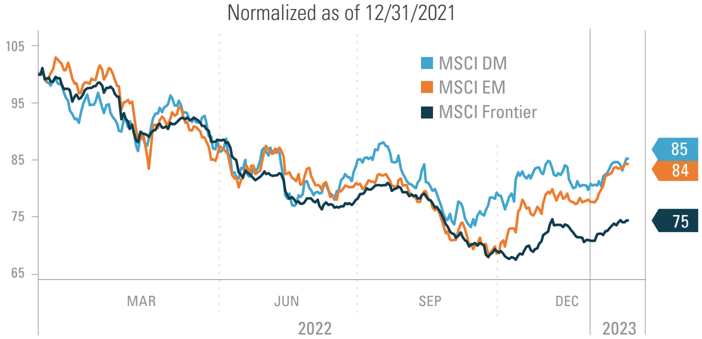


[1] All data and statistics cited are sourced from Bloomberg, January 2023 unless otherwise noted

Global equity markets remain vulnerable to renewed selling. Long-term equity bulls are saying markets should look through the recession, but this is impossible to do when it hasn't even happened yet. We have no idea yet how deep or long the downturn may be, which means we have not seen how bad the hit to earnings will be. Nor do we know how high U.S. interest rates will go, which is important for discounting equity prices. We also do not believe the rest of the world can escape recession. We believe most of the 2020-2021 global equity rally was driven by excess liquidity stemming from zero rates and Quantitative Easing by virtually every major central bank. Now that rates are rising significantly and Quantitative Tightening is under way, it stands to reason that equity markets should move lower as a result.

MSCI Equity Indices

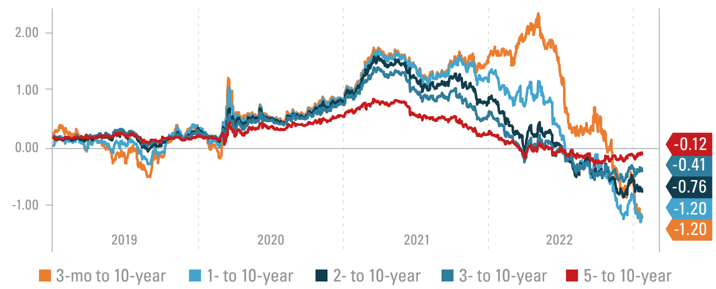
Normalized as of 12/31/2021



Curve Inversion is Upon Us

As the Fed tightens, the markets have paid close attention to the shape of the U.S. yield curve. The 2- to 10-year curve inverted back in early July 2022 and currently stands near -70 bp. It fell as low as -84 bp in early December and had not been that inverted since 2000. However, several San Francisco Fed studies suggest that the 3-month to 10-year curve is the best at predicting U.S. recessions. It inverted back in November 2022 for the first time since early 2020 and moved as low as -127 bp in January before recovering to near -115 bp currently. This inversion of the 3-month to 10-year signals that a recession is very likely this year. The New York Fed estimates that the risk of a recession within 12 months was around 50% in December, up from only 4% in May and 6% in June.[2] January has not been estimated yet but with the yield curve getting further inverted, the odds will likely rise further.

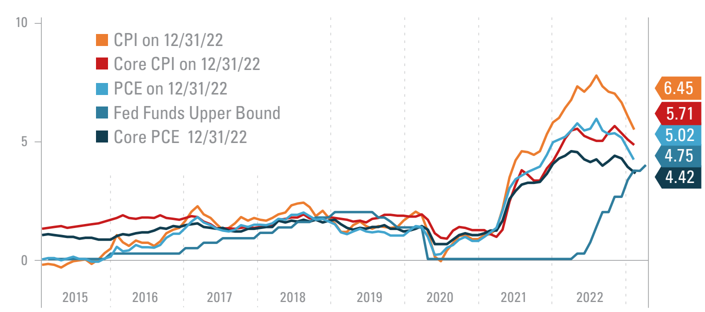
U.S. Yield Curve, percentage points



When the Fed Speaks, and How the Market Reacts

The two-day FOMC meeting ended February 1 with a 25 bp hike in the target range to 4.5-4.75%, as expected. While the Fed's statement was largely by the book, the cracks in the hawkish façade came in Powell's Q&A. He said the Fed will move rates beyond the December projections if needed, adding that policy is not yet sufficiently restrictive whilst stressing that the Fed has no incentive nor desire to overtighten. This sounded quite equivocal. Powell also played up recent disinflation, noting that it was "gratifying" to see the process under way and seeing progress on lowering inflation without any weakening in the labor market. He seems confident that the Fed can get inflation back to target without causing a deep recession, which seems to us like he's declaring victory a bit early. Indeed, we get the sense that the Fed is getting a bit too complacent in believing the soft landing theme, just as the markets are. We just don't think it's going to be this easy. Of note, new Dot Plots and macro forecasts won't be published until the March 21-22, 2023 Federal Open Market Committee (FOMC) meeting.

U.S. Inflation, y/y



[2] Federal Reserve Bank of New York, The Yield Curve as a Leading Indicator (January 2023)

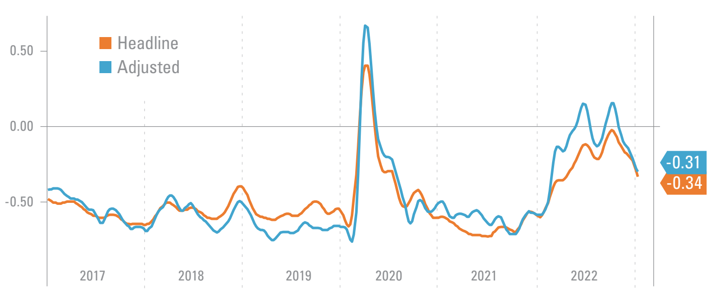
When asked, Powell did not push back at all against the current looseness in financial conditions. He spoke about the Fed focusing on sustained changes in financial conditions but did not use the opportunity to say that the current loosening was unwarranted. We note that through late January, financial conditions as measured by the Chicago Fed were the loosest since mid-April, with its adjusted measure the loosest since mid-February. Given the market reaction to the FOMC decision, that means conditions will loosen even more.

Median Fed Forecasts from December (September)

	FY22	FY23	FY24	FY25
GDP Growth	0.5% (0.2%)	0.5% (1.2%)	1.6% (1.7%)	1.8% (1.8%)
Core PCE	4.8% (4.5%)	3.5% (3.1%)	2.5% (2.3%)	2.1% (2.1%)
Fed Funds Rate	4.4% (4.4%)	5.1% (4.6%)	4.1% (3.9%)	3.1% (2.9%)
Unemployment	3.7% (3.8%)	4.6% (4.4%)	4.6% (4.4%)	4.5% (4.3%)

Board of Governors of the Federal Reserve, Summary of Economic Projections, December 14, 2022

Chicago Fed U.S. Financial Conditions



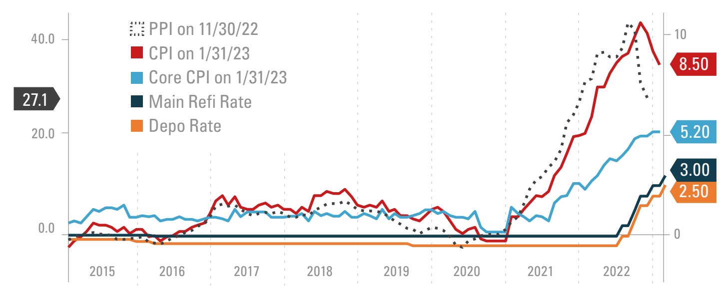
Risk Off Event Lurks

The U.S. debt ceiling remains an underappreciated risk. The debt ceiling has been hit and Treasury will now resort to "extraordinary measures" to avoid default and buy some time until Congress either raises the US$31.4 trillion ceiling or suspends it again. Treasury Secretary Yellen warned that it's "critical that Congress act in a timely manner. Failure to meet the government's obligations would cause irreparable harm to the U.S. economy, the livelihoods of all Americans, and global financial stability. Indeed, in the past, even threats that the U.S. government might fail to meet its obligations have caused real harms, including the only credit rating downgrade in the history of our nation in 2011."[3] This is a potential risk off event that has not gotten much attention even as both parties dig in. Most estimates show the drop-dead date for when the government runs out of money sometime this summer. We expect the contours of the negotiations to become clearer in Q1, with tensions and market impact likely to be seen in Q2 as that drop dead date approaches.

ECB Hawks Remain in Charge… For Now

The European Central Bank (ECB) hiked the deposit rates 50 bp to 3.0% on February 2. Here too, the statement was quite hawkish. It expects to raise rates further and highlighted another 50 bp hike was likely at the next meeting March 16. The fireworks began during President Lagarde's press conference. She noted that risks to the inflation outlook have become more balanced and added that this latest decision wasn't a decision for March, directly contradicting the ECB statement. She said the risk assessment was "rather consensual." Lagarde added that intentions with regards to the March hike are not "irrevocable" and that intent is not 100% commitment. It's clear that the lower than expected January CPI readings have reopened the fissures between the ECB hawks and doves and these fissures will likely widen ahead of the March 16 meeting. If inflation continues to fall, we expect ECB tightening expectations to fall from the current expected terminal rate near 3.5% to 3.25% or perhaps even 3.0%, where it stood back in December.

Eurozone Inflation, y/y



German officials are getting a bit too optimistic. Bundesbank President Kuehne Nagel predicted that "We will get inflation under control in such a manner that what many fear does not occur, namely that is does not come to a recession in the euro area."[4] Elsewhere, Chancellor Scholz said recently that Germany would avoid recession. We think it's awfully early to declare victory, especially since core inflation continues to accelerate. Yes, some sentiment indicators have improved in recent months but the bulk of the ECB's 300 bp of tightening hasn't really been felt yet due to the lags in monetary policy. With another 100 bp of tightening expected this year, it's hard to see how the eurozone will avoid recession. The warmer than normal weather has helped, as has news of China reopening, but we don't think that's enough to stave off recession. We believe we are close to peak eurozone sentiment, which should mean a reversal ahead in favor of the U.S.

[3] Letter from U.S. Secretary of the Treasury to Janet L. Yellen to the Honorable Kevin McCarthy, Speaker U.S. House of Representatives, January 13, 2023
[4] https://www.econostream-media.com/news/2023-01-23/ecb%E2%80%99s_nagel:_expect_euro_area_inflation_to_be_back_at_2_end-2024_2025.html

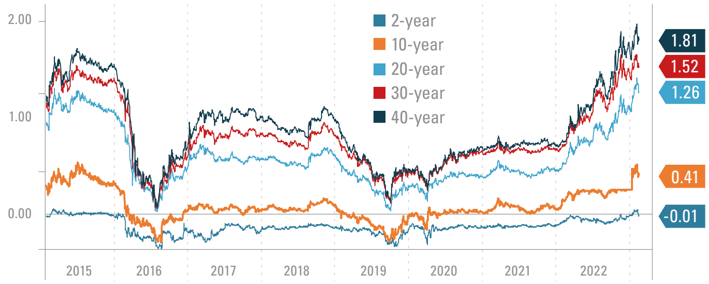
Bank of Japan pivots… or does it?

The two-day Bank of Japan (BOJ) meeting December 19-20 ended with an unexpected tweak to Yield Curve Control. The 0% target for the 10-year JGB yield was maintained but the tolerance band was widened to +/- 50 bp vs. +/- 25 bp previously. Governor Haruhiko Kuroda stressed that the move did not represent tightening and that it was made to improve market functioning. While the policy rate was kept at -0.10%, speculation has grown for an eventual rate hike this year.

At the next meeting January 17-18, the BOJ left all policy settings unchanged. Most importantly, its updated macro forecasts suggested no urgency to tighten as core inflation is seen moving back below the 2% target in both FY23 and FY24. Governor Kuroda remains dovish and shows no signs of pivoting despite the December surprise. With inflation still rising, the updated forecasts and the tweak to Yield Curve Control (YCC) remain all the more puzzling. While we expect liftoff to come in H1, we think it will be a very gradual process. Indeed, the swaps market is pricing in a policy rate near 0.10% in one year, 0.25% in two years, and 0.35% in three years.

We thought liftoff was an H2 prospect, but the December move on YCC suggests it could happen in H1 instead. Furthermore, given Governor Kuroda's propensity for surprises, this hike could come under his watch rather than his successor's. Of note, Bloomberg's world interest rate probabilities (WIRP) function suggests 20% odds of liftoff March 10, rising to nearly 50% April 28 and nearly priced in June 16. Looking further ahead, the swaps market sees the policy rate at 0.10% in one year, 0.25% in two years, and 0.40% in three years. We see some upside risks to these rates but continue to believe that any BOJ tightening will ultimately be done at a very modest pace.

Japan Yields, %



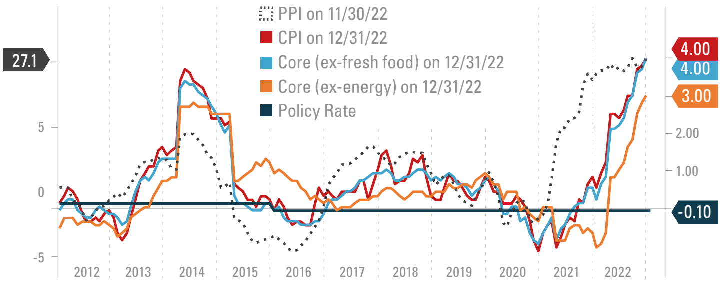
BOJ Forecasts from August (May)

	FY22	FY23	FY24
GDP Growth	1.9% (2.0%)	1.7% (1.9%)	1.1% (1.5%)
Core CPI (ex-fresh food)	3.0% (2.9%)	1.6% (1.6%)	1.8% (1.6%)

Source: Outlook for Economic Activity and Prices January 2023

Markets will surely continue to test the new trading band. Tweaking the trading band is akin to adjusting a currency peg in FX; once policymakers start tweaking the parameters of the peg, the markets tend to smell blood in the water and attack. YCC been tested sporadically this past year, but the BOJ has so far successfully defended it. It will probably do so again but even a successful defense may hasten the eventual demise of YCC. Simply put, the BOJ has too many targets and not enough instruments to meet them.

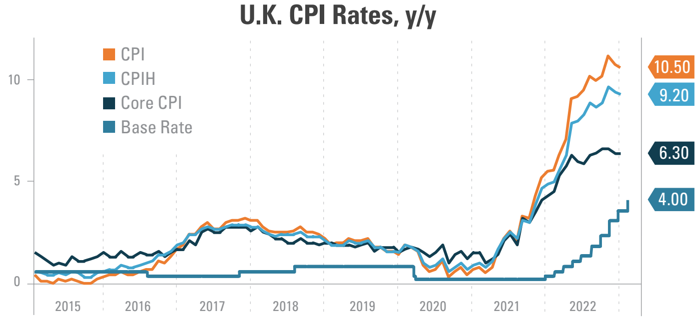
Japan Inflation, y/y



Kuroda's replacement has not been named yet but the choice will be key in determining the timing of BOJ policy normalization. The two Deputy Governors Masayoshi Amamiya and Masazumi Wakatabe are still seen as potential successors to Governor Kuroda, along with former Deputy Governor Hiroshi Nakaso. Many at the BOJ believe that besides hitting the 2% inflation target, higher wages are also needed to justify liftoff. Amamiya has expressed concern about rising wages next fiscal year, while Wakatabe has sounded less concerned. Of note, both of their terms end in late March but they are widely expected to be appointed to second 5-year terms. Another potential candidate is former Deputy Governor Hiroshi Nakaso, who served during Kuroda's first term and currently heads up a private sector research institute. We hope to see some hints of progress on the succession process soon.

Other Major Central Banks Will Continue to Tighten

U.K. CPI Rates, y/y



BANK OF ENGLAND

- The Bank of England hiked rates 50 bp to 4.0% at its February 2 meeting
- The 7-2 vote showed Swati Dhingra and Silvana Tenreyro still voting to keep rates steady and Catherine Mann moving to the majority and voting for 50 bp vs. 75 bp at the December meeting
- Updated macro forecasts for lower inflation and higher growth were way too optimistic
- The market expects another 25 bp hike in either March or May, while odds of a last 25 bp hike to 4.5% in June or July stand below 50%
- That suggests the policy rate will peak between 4.25-4.5%, down sharply from 6.25% right after the disastrous mini-budget in late September

SWISS NATIONAL BANK

- The Swiss National Bank hiked rates 50 bp to 1.0% at the last meeting December 15
- The new 2023 growth forecast came in at 0.5%
- With inflation showing signs of peaking, the swaps market is pricing in a peak policy rate near 1.5%, down from 2.5% back in December

BANK OF CANADA

- Bank of Canada hiked rates 25 bp to 4.5% at its January 25 meeting and signaled a pause
- The labor market remained red hot in December as 100k jobs created (mostly full-time) helped push the unemployment rate down to 5.0%, just a tick above the cycle low from this past summer
- The swaps market is pricing in one more 25 bp hike
- Recent data have come in firm, and so we see risks of a peak policy rate that's higher than the 4.75% that markets are pricing in

RESERVE BANK OF AUSTRALIA

- Reserve Bank of Australia hiked rates 25 bp to 3.10% at its December 6 meeting
- The next policy meeting is February 7 and WIRP suggests over 50% odds of a 25 bp hike, while the swaps market is pricing in a peak policy rate near 3.55%, down from 3.85% at the start of the year
- Given that inflation is rising again despite the 300 bp of tightening seen so far, we believe there are upside risks to the terminal rate

RESERVE BANK OF NEW ZEALAND

- The RBNZ hiked rates 75 bp at its November 23 meeting and shifted its expected rate path upwards
- Next policy meeting is February 22 and WIRP suggests that a 50 bp hike is fully priced in, with over 50% odds of larger 75 bp move
- The swaps market is pricing in a peak policy rate near 5.5%, which matches the bank's expected rate path.

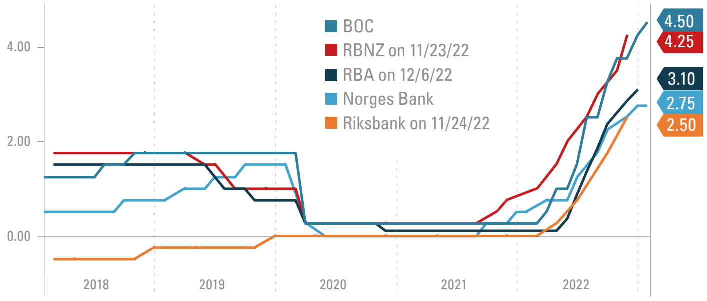
NORGES BANK

- At the last policy meeting January 20, Norges Bank kept rates steady at 2.75%
- The expected rate path from December saw the policy rate peaking near 3.0%, with gradual easing expected in H2 2024
- The swaps market is now pricing in a peak policy rate near 2.75% vs. 3.25% right after the December meeting.

RIKSBANK

- At the last policy meeting November 24, the Riksbank hiked rates 75 bp to 2.5%
- Next policy meeting is February 9 and will be led by incoming Governor Erik Thedeen after Ingves' term ended December 31
- WIRP suggests another 50 bp hike to 3.0% February 9 is fully priced in with nearly 50% odds of a larger 75 bp move
- The swaps market is pricing in a peak policy rate near 3.5%.

Dollar Bloc and Scandie Policy Rates



EMERGING MARKETS GLOBAL OVERVIEW

China's Reopening and What it Means for Emerging Markets

Emerging markets assets have been lent some support

Notions of a Fed pivot and China reopening have lent Emerging Markets (EM) assets some support in recent weeks. We've already discussed the Fed pivot in our section on the major markets. Here, we focus on China reopening and the implications for EM. Simply put, China's abrupt abandonment of its Covid Zero policy last month has fed into optimism that the world's second largest economy will get back on track after last year's subpar growth. The MSCI EM has rallied nearly 25% since the October trough, when it traded at the lowest since April 2020. However, it has only recouped about 30% of its losses from the February 2021 peak. Part of this rally is due to the Fed pivot story, while the other part is due to China reopening.

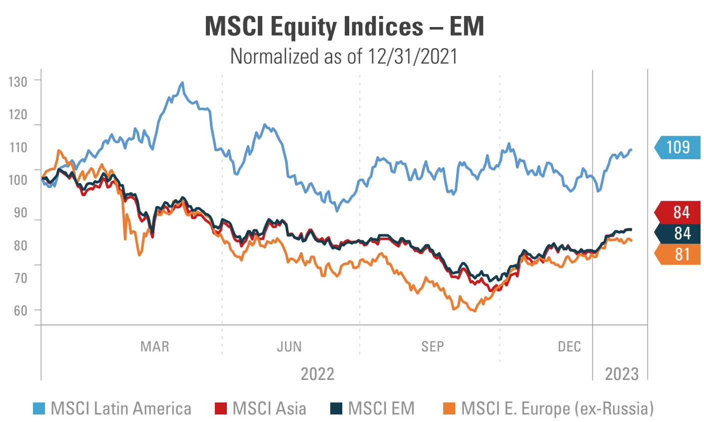
Despite the recent bounce, EM as an asset class is likely to remain vulnerable in 2023. We continue to look through the improved sentiment and see the global backdrop for EM and other risk assets as very challenging still. We believe virtually every central bank in the world will continue tightening monetary policy this year and so liquidity that once flowed easily into EM will continue to dry up. Recent inflation readings from the dollar bloc and Scandie nations suggest that the battle is not yet over and that most major central banks will very likely have to go "higher for longer." China reopening is likely to add to global inflation impulses. We also believe that China's reopening will be anything but smooth in terms of the real economy. Covid deaths have spiked and many believe the official numbers are understating the problem. As a result, the mainland recovery is likely to be uneven and choppy.

Weaker credits are expected to continue to struggle with external financing. Frontier Markets such as Sri Lanka, Pakistan, Bangladesh, Egypt, and Ghana have already come under stress. However, this is not what we consider to be contagion. Rather, every country is currently facing the same problems of tighter global liquidity and falling risk appetite. Those countries with strong fundamentals should weather the storm, while those with weak fundamentals will likely suffer the most. The stronger EM credits saw some pressure on their currencies but have remained able to tap global markets for liquidity, albeit at a higher cost.

The good news for the weaker credits is that the IMF remains open for business. Egypt, Tunisia, Sri Lanka, Zambia, Tanzania, Georgia, Moldova, Mozambique, and Argentina have entered into traditional IMF support programs over the past year. Bangladesh and Ghana remain in talks with the IMF and are likely to eventually enter into IMF programs too. Of note, Chile, Peru, and Colombia gained access to the Flexible Credit Line, a preventative program that's reserved for countries with strong underlying fundamentals. This is the exactly the IMF's role during times of market stress.

Global recessions risks remain high.[1] Earlier this month, the World Bank updated its forecasts and slashed its outlook for global growth this year to 1.7% vs. 3.0% forecast last June. According to the lender, this would be the third weakest reading in nearly three decades, with the only exceptions being the Great Financial Crisis in 2009 and the global pandemic in 2020. Growth in the advanced economies is expected to slow to 0.5% this year from 2.5% in 2022. Despite reopening, we believe China continues to pose big risks to global growth. The World Bank sees China growing 4.3% this year and 5.0% next year, up from 2.9% in 2022. Here, we see downside risks ahead.

The regional EM breakdown from the World Bank forecasts is worth noting.[2] Growth in Asia is expected to pick up to 4.3% this year from 3.2% in 2022, while growth in Europe is expected to slow to 0.1% from 0.2% in 2022. Lastly, growth in Latin America is expected to slow to 1.3% this year from 3.6% in 2022. Since 2022 began, regional equity market performance has been dictated largely by divergences in their respective growth prospects. If this trend continues, Latin America and Asia should continue to outperform while Europe should continue to underperform.



President Xi's Third Term Has So Far Been Unpredictable

As expected, President Xi won a third term at the 20th National Congress of the Chinese Communist Party last fall. Furthermore, Xi filled the Politburo and its top Standing Committee with loyalists. As a result, China has come full circle back to one-man rule that it had moved away from after Mao. Checks and balances have been substantially eroded. Of note, Premier Li, PBOC Governor Yi, and other senior members of the economic team were left off of the larger Central Committee. While this does not automatically mean they will step down from their posts, all are around the official retirement age of 65 and are likely to step down early this year. The changing of the guard comes at a difficult time for the mainland economy and should be seen as a risky move.

[1] World Bank Global Economic Prospects, January 2023.

[2] World Bank Global Economic Prospects, January 2023.

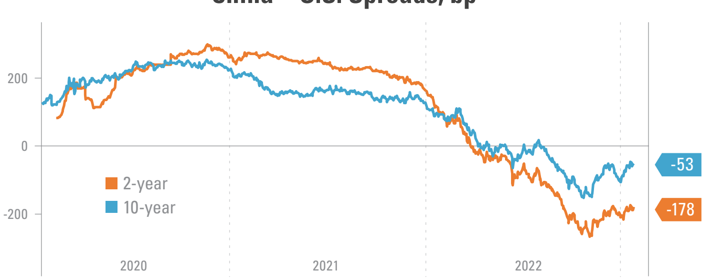
President Xi Jinping has already provided several surprises. Protests in December led to a surprising reversal of Xi's controversial Covid Zero policy. In what many observers termed the largest display of civil disobedience since Tiananmen Square in 1989, China's populace achieved the unthinkable as Xi quickly reversed course on Covid Zero and announced a loosening of restrictions. In another reversal, policymakers have increased support for the beleaguered property sector by boosting targeted lending and other measures. These developments have led foreign investment to return to China after a dismal 2022 (see below). On the other hand, tensions with the U.S. over Taiwan are likely to continue as President Xi sticks to his goal of eventual reunification and so some caution is warranted.

MSCI Equity Indices – China

Normalized as of 12/31/2021

Capital flows have turned around but are likely to remain fickle. Last year, several factors led to significant capital outflows from China. These outflows were not only due to the unfriendly environment for foreign investment, but also due to onshore investors seeking higher returns outside of the country. This was a significant turnaround from 2020 and 2021, when high local rates drew in foreign investors searching for yield. Interest rate differentials favoring the U.S. peaked in November but have since moved back a bit in China's favor. That along with the end of Covid Zero policies have led foreign investors to come back once again to China, in turning helping the yuan firm. With central bank divergences likely to continue well into 2023, we see yuan weakness resuming in the coming months.

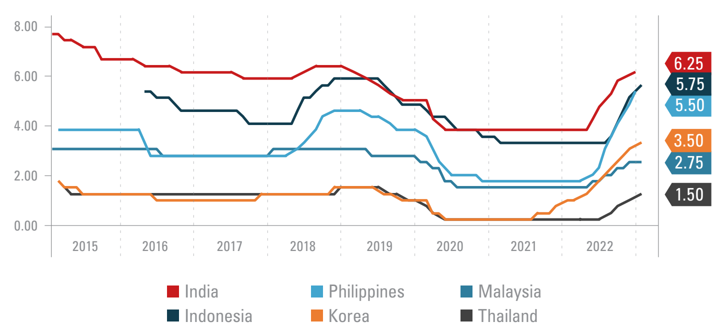
China – U.S. Spreads, bp



Asia Stands to Benefit the Most From China's Reopening

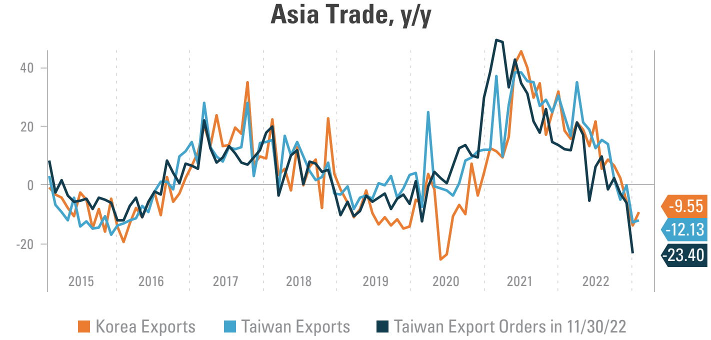
Most Asian central banks have undergone modest tightening cycles. However, the pervasiveness of administered prices in this region has limited the pickup in inflation and allowed these central banks to hike quite gradually compared to the other EM regions. At 6.25%, India's policy rate is currently the highest in the region, but the Reserve Bank of India (RBI) is nearing the end of its tightening cycle. Indonesia and the Philippines also stand out for their more aggressive tightening cycle, but both are also nearing the end of their cycles. Singapore also stands out as it has tightened five times this past year by adjusting its Singapore dollar nominal effective exchange rate (S$NEER), most recently at its October meeting.

Asia Policy Rates



Regional exports have cooled significantly in recent months as the chill from China spreads outward. The largest EM exporters to China are Korea, Taiwan, Brazil, and Malaysia. And it's not just EM; Japan and Australia are two of the top four exporters to China overall. Even though China is reopening, we believe policymakers there will continue to look more inward. As such, the regional exporters will have to find a different source of growth and it won't be easy in the short run with the rest of the world slipping into recession.

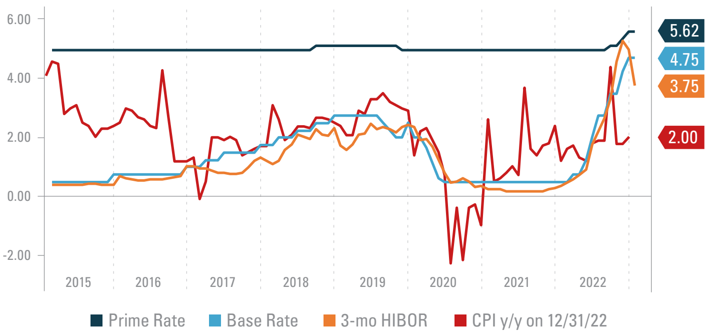
Asia Trade, y/y



HONG KONG

- The Hong Kong dollar (HKD) has come under pressure again
- Due largely to Hong Kong's special role as a conduit into and out of the mainland markets, capital flows have a direct impact on HKD though
- We believe the Hong Kong Monetary Authority (HKMA) will continue to successfully defend the peg but at a cost to growth

Hong Kong Rates



INDIA

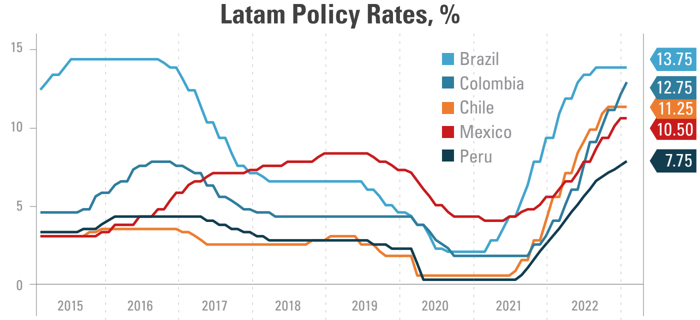
- Due to aggressive tightening by the RBI, inflation has peaked and is back within the 2-6% target range
- Growth remains robust, with GDP expected to grow nearly 7% this year vs. almost 9% last year
- India's large domestic market should help it outperform the more export-dependent regional economies

Latin America Outperformance Could Ebb

The region was the first to hike and it hiked aggressively. Brazil led the charge by hiking first in March 2021 and taking rates from 2.0% up to 13.75%. Chile was similarly an early tightener, hiking first in July 2021 and taking rates from 0.50% up to 11.25%. Both have signaled an end to their tightening cycles. Mexico also started early, hiking first in June 2021 and taking rates from 4.0% up to 10.5% currently. However, it has not ended its cycle and markets are pricing in a peak policy rate of 11.0%. Colombia started a little later, hiking first in October 2021 and taking rates from 1.75% up to 12.75% currently. Here too, markets are expecting further tightening and pricing in a peak policy rate of 13.50%. Lastly, Peru has been the least aggressive in the region, hiking first in August 2021 but only taking rates from 0.25% up to 7.75% currently.

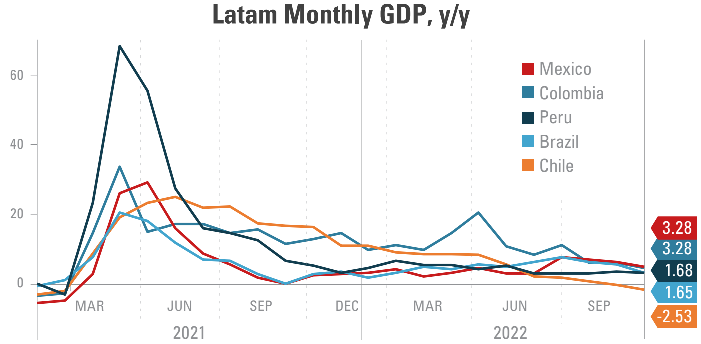
This aggressive tightening has given these regional currencies a leg up on others in EM. The positive carry is much higher than what one can get in Asia or EMEA and so it's no surprise that BRL, MXN, PEN, and CLP were the top four performers in 2022 within EM FX, eking out small gains against the dollar even as the rest of their peers fell. That outperformance has carried over into 2023, as COP, CLP, and MXN are three of the top six performers YTD within EM FX. We believe investors will continue to reward Latin American currencies for running orthodox and predictable monetary policy.

Latam Policy Rates, %



The aggressive tightening cycles have exacted a cost in terms of slower growth. Higher interest rates have weighed on regional growth this past year, but the slowdown seems to be bottoming. With the exception of Chile, GDP growth has stabilized for the major regional economies. In addition, the China reopening story will help Latin American equity markets via higher commodity prices. As noted earlier, Latin American equities outperformed within EM last year and this should continue in 2023 as well.

Latam Monthly GDP, y/y



BRAZIL

- We saw a peaceful transition of power January 1 after former Brazilian President Lula da Silva eked out a 50.9-49.1% win over incumbent President Jair Bolsonaro
- The nation was unexpectedly rocked by violent protests in Brasilia January 8 as pro-Bolsonaro forces called for the military to intervene
- The military upheld its duty and the coup attempt failed, but there have been reports that the protests were funded by some business interests and supported by some pro-Bolsonaro government officials
- Investigations have already begun, but it will likely be some time before investor concerns have been allayed

PERU

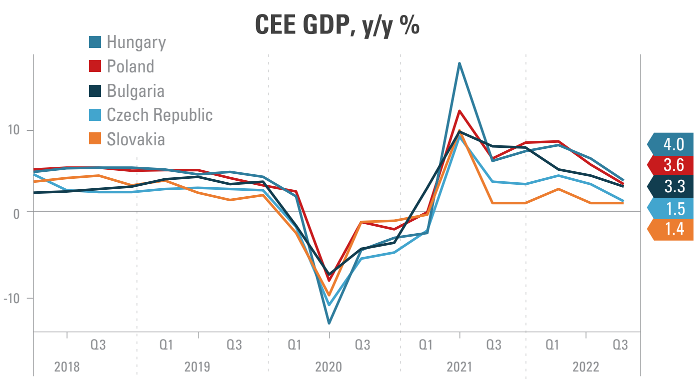
- After dissolving congress hours before an impeachment vote in December, President Castillo was met with stiff opposition from the military, the judiciary, and member of his own cabinet
- Congress eventually voted overwhelmingly to impeach Castillo, who was eventually arrested
- Vice President Boluarte hoped to finish out Castillo's five-year term, but protests have already led her to move elections forward to April 2024 from April 2026 originally
- More protests demanding Boularte's resignation have spread throughout the country since the failed coup attempt

CHILE

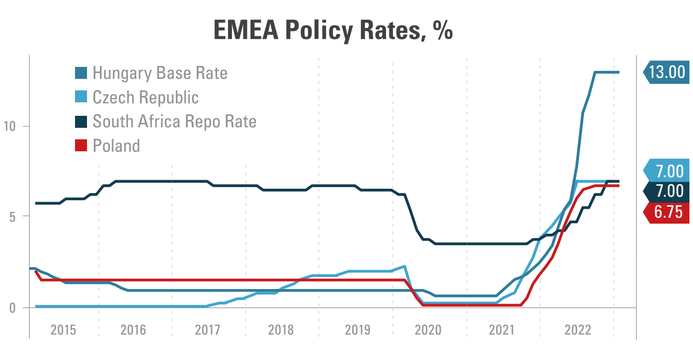
- The new Chilean Constitution was resoundingly rejected by a margin of 62-38% in the September 4 referendum
- The constitutional process begins anew in January, as the so-called Experts Commission will be created with 24 members, half appointed by the Senate and half by the Lower House
- Once appointed January 24-25, the Experts Commission will start deliberating March 6 and will have three months to write the first draft of the new Constitution
- In a promising sign, President Gabriel Boric promised to achieve a broader consensus in the next stage of the constitutional process.

CEE remains very vulnerable

With Western Europe still seeing high recession risks, Eastern Europe is expected to feel the pain. The lion's share of CEE exports go to the eurozone. Poland's top export destinations are Germany, France, and the Netherlands. For Czech Republic, they are Germany and Slovakia. For Hungary, they are Germany, Romania, and Italy. We believe CEE policymakers are getting increasingly concerned about the economic headwinds that are building. Warmer than expected weather along with recent improvements in eurozone sentiment indicators have fed into optimism that the downturn will be short and shallow, but we believe it's too early to say with any certainty.



No wonder then that most of the region's major central banks have pivoted. The recent decision by the Czech National Bank to end its tightening cycle is risky with inflation running at 18% and still rising. The National Bank of Poland too is signaling that it is nearing an end to its tightening cycle despite inflation running near 18%. Surprisingly, the Hungarian National Bank has been the most aggressive in hiking rates but signaled the end of the tightening cycle in September even with inflation running over 20%. All three policy rates appear too low to contain rising price pressures.

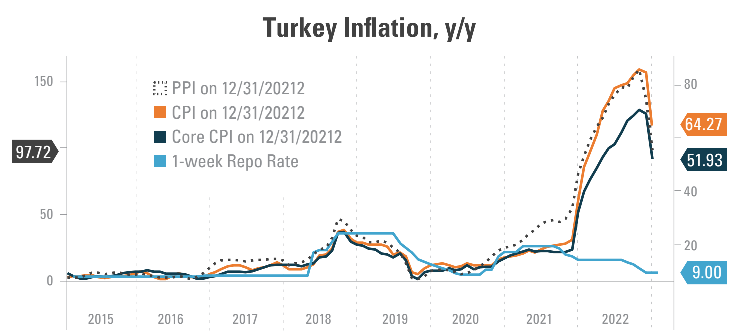


HUNGARY

- Fitch recently cut the outlook for Hungary's BBB sovereign rating to negative to stable
- The agency noted "A tougher international environment, including higher global interest rates, volatile energy prices and weakening demand from key trading partners is exposing vulnerabilities stemming from a policy mix that is influenced by political considerations."[3]
- It added that "Fitch sees a high probability of delays in the disbursement of EU funds. Although the direct impact of a delay in disbursements on medium-term growth and external finances would be modest, in Fitch's opinion it would raise further questions over policy credibility, highlight governance challenges and potentially hurt investor sentiment."[4]

TURKEY

- With inflation running hot, the Central Bank has still managed to cut rates
- At the policy meeting December 22, the Central Bank delivered its fourth cut in a row with a final 150 bp move that took the policy down to 9.0%
- We believe monetary policy has entered a new phase and that further easing will come ahead of June elections in the form of macroprudential measures
- As a result, the country is likely to continue to careen towards a full-blown economic crisis due to an unsustainable policy mix



[3] Fitch Ratings, January 20, 2023

[4] World Bank Global Economic Prospects, January 2023.

DISCLOSURES

FOREIGNEXCHANGE

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