FX Viewpoint

# Hedging a potential USD bounce in Q1

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G10 FX Strategy
Global

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## Bearish USD for '24 consensus and positioning is short

Bearish USD has been one of the top FX views in our 2024 Year Ahead publication (see G10 FX Year Ahead from 20 Nov '23). While we believe the USD has more room to sell off by YE '24, in the short-term the bearish USD view appears to be consensus with investors now net short. A USD bounce is a top risk for many macro investors. Here we discuss potential drivers for a near-term USD rally and ways to hedge this risk.

## Scenario 1: An equity shock-driven USD rally

We believe a USD rally in Q1 is more likely driven by an equity risk-off shock than higher US yields. Our rates strategists continue to favor trading the recent range in yields with a bullish bias. They see 2yT at c.4% by year-end, with risks skewed to the downside, reflecting expectations for 4 Fed cuts in '24. In US equities, on the other hand, 4Q23 return ranks at a 94th percentile since '99. Geopolitical risks and macro events beyond the Fed may drive risk assets lower, supporting a USD rally.

## Hedging scenario 1

3m 25d USD risk reversals vs cyclical G10 currencies like AUD, NZD and CAD look attractive as hedges for a scenario of an equity-driven USD rally. Since the 4Q23 USD selloff, short-dated risk reversals in these pairs have tilted to historically stretched level for USD puts. Cyclical currencies tend to weaken more vs the USD during risk-off equity selloffs and this should lead to some normalization of risk reversal for USD calls. Risks to these structures would be a resilient equity market in 1Q23.

## Scenario 2: Data weakness outside of US

Negative economic data surprises outside of the US are also potential catalysts for a USD rally. Indeed, widening growth differentials between the US and rest of the world triggered the 2-months USD rally in 3Q23. We may see a repeat of this dynamic driven by weakness in overseas macro data.

## Hedging scenario 2

We favor calendar spread structures to hedge scenarios where USD appreciates short term due to overseas macroeconomic weakness, but still sells off for 2024 as a whole in accordance with our core view. Recent data suggest that Canada and Sweden are the most vulnerable in G10. For investors that believe a USD selloff in '24 may be more backloaded, a 3m9m ATMF USD calendar put spread (own 9m USD put funded by 3m USD put) could cheapen the premium by around 50% compared an outright 9m USD put for the likes of CAD and SEK. The risk to this scenario would be resilient non-US economic data and a USD sells off earlier rather than later in '24.

CFTC: Commodity Futures Trading Commission

DXY: US Dollar Index

OTMF: out-of-money forward

ATMF: at-the-money forward

## Bearish USD for '24 is consensus and positioning is short

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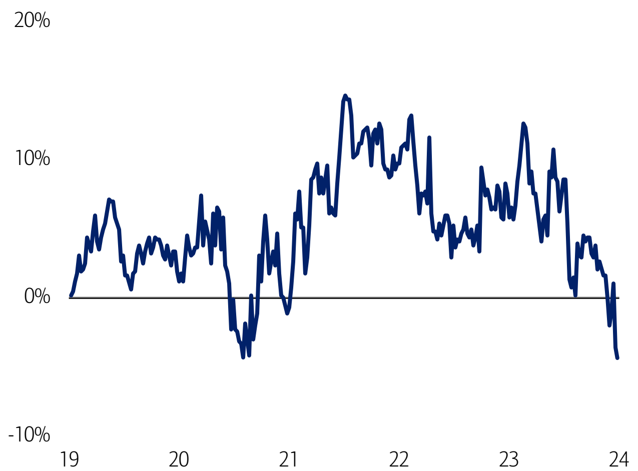
- also reflects an increase in USD underweight recently (both exposures and views - see Exhibit 2), albeit less so than the recent peak USD short in '20…
- … and a market bias towards soft landing scenarios and the view that the end of US growth outperformance vs the rest of the world supports fading the USD richness.

Significantly, we see soft landing scenarios priced to perfection currently (see US Vol – Steady as rates consolidate), and scope to hedge a wide range of outcomes around this baseline. A near-term USD bounce is likely to be a top risk for many macro investors. In this publication we discuss potential drivers for a brief USD rally (two tail scenarios, in particular) and ways to hedge this risk in FX vol space.

**Exhibit 1: CFTC shows speculative USD positioning turned net short**
CFTC net USD positioning as % of open interest




**Source:** BofA Global Research, Bloomberg, CFTC

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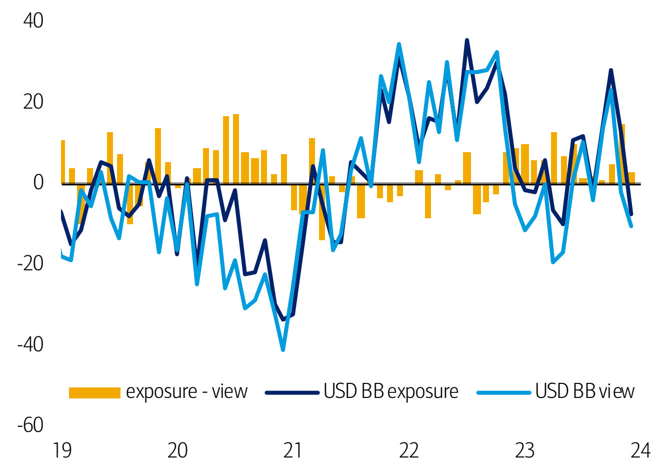
**Exhibit 2: FX exposure and view: USD**
Both sentiment and views extend into more bearish territory




**Source:** BofA Global Research FX and Rates Sentiment Survey

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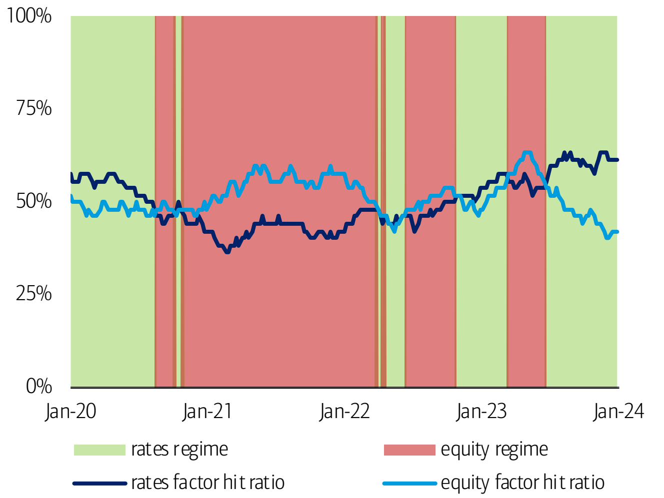
## Scenario 1: A near-term equity driven USD rally

We believe any near-term USD upside is more likely to be equity factor-driven than rates-factor driven. To differentiate between equity vs rates driven FX regimes, our CARS (cross-asset regime switching) model (see latest signals in FX Quant Insight from 8 Jan '24) tracks rolling performance of equity and rates factors for FX (see Exhibit 3).

For most of the global rate hiking cycle since '22, the FX market has been under a rates regime than an equity regime, meaning FX investors have been better off generating directional FX signals using global rate levels/changes than using global equity market returns. Back in '20-21, the FX market was driven more by the equity factor as global yields were broadly near the zero-lower bound under dovish central bank monetary policies. Cross-asset factors for FX briefly moved into an equity regime in 2Q23 after the US regional bank shock (see The growth regime for FX from 11 Apr '23, and the regime shift in policy expectations post the banking shock in Exhibit 4), but quickly reverted back to a regime base on rates/Fed communication.

**Exhibit 3: FX market traded under a rates regime for most of '23**
Rolling hit ratios between rates and equity factors in CARS model for FX




**Source:** BofA Global Research, Bloomberg. Period with higher hit ratio for rates factor is denoted as rates regime; period with higher hit ratio for equity factor is denoted as equity regime.
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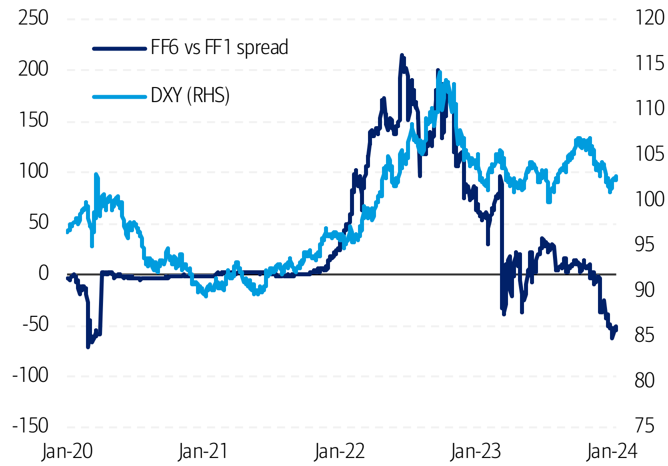
**Exhibit 4: Dollar index vs monetary policy expectations**
Reset of policy expectations around the Q223 US banking shock risk off context drove temporary shift away from rates regime for the FX dynamic




**Source:** BofA Global research; Bloomberg
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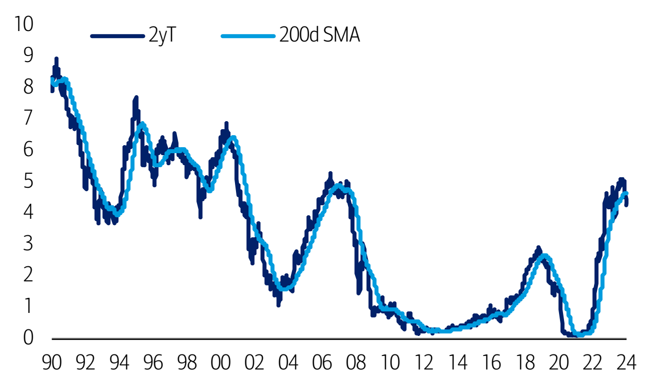
## Empirical data sees low probability for yield surge after crossing 200d SMA

Under a rates regime, USD rallies in this cycle have coincided with rising US yields (generally with hawkish monetary policy expectations– see Exhibit 4). Recently, however, 2yT yields fell by more than 25bp below the 200d SMA. Empirical results since the '90s show that the probability of another US yield surge in '24 is materially reduced when this happens. Historically, a 25bp dip in 2yT yield below the 200d SMA has signaled the start of cyclical downtrend, with the 2yT yields on average taking 68 weeks to rise by +25 bp above the 200d SMA again (see Exhibit 5). The 2yT yield could retest the 200d SMA, but 81% of the time it had stayed below the 200d SMA after 26 weeks. For context, our rates strategists also see 2yT at c.4% by year-end (see Global Rates Weekly from 15 Dec '23) reflecting expectations for 4 Fed cuts in '24.

**Exhibit 5: 2yT dropped by 25bp below its 200d SMA at the end of December '23 for the first time since '19**
2y Treasury yield vs 200d SMA




**Source:** BofA Global Research, Bloomberg
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**Exhibit 6: 11% 4Q23 equity return ranks at 94th percentile since '99**
QoQ return for S&P 500


**Source:** BofA Global Research, Bloomberg
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On the other hand, the US equity market had an outsized rally recently. A 11% QoQ return for the S&P 500 over 4Q23 ranks at a 94th percentile since '99 (Exhibit 6). Lack of a "Santa rally" at the end-Dec may suggest a tactical hangover for US equities early in the year before the market sees more gains in '24 (see Market Analysis Comment from 3 Jan '24). Geopolitical risks and macro events beyond the Fed may also drive equities lower even as US yields maintain a downtrend (see The RIC Report: Ten surprises for '24 from 9 Jan '24).

### 3m USD risk reversals vs AUD, NZD and CAD to hedge equity-driven USD rally

Equity weakness in the absence of a US yield resurgence would be more akin to a traditional risk-off shock, where cyclical "high-beta" currencies underperform the USD by more than low-yielding currencies such as JPY and CHF.

Under this scenario, we would expect cheap 3m 25d USD risk reversals vs AUD, NZD, and CAD to be an appropriate hedge. With the USD spot lower in 4Q23, 3m 25d USD risk reversals have sharply moved for USD puts, currently sitting at 19th percentile vs the past decade (see Exhibit 7). Across USD/G10 pairs, USD call risk premiums have been the most aggressively reduced for AUD, NZD, and CAD (see Exhibit 8). In the EM FX space, the move for USD puts in pairs like USDINR and USDTWD appeared to be even more extreme, with 3m risk reversal briefly falling into negative territory. In the event of a traditional risk-off led USD bounce back, we would expect short-dated risk reversals to quickly normalize for USD calls vs these so-called "high-beta" G10 FX currencies. The key risk to these structures would be a resilient equity market in 1Q23.

**Exhibit 7: 3m risk reversal moved sharply for USD puts since Nov '23 (currently at 19th percentile vs the past 10 years)**
Avg of 3m 25d USD/G10 risk reversals


**Source:** BofA Global Research, Bloomberg
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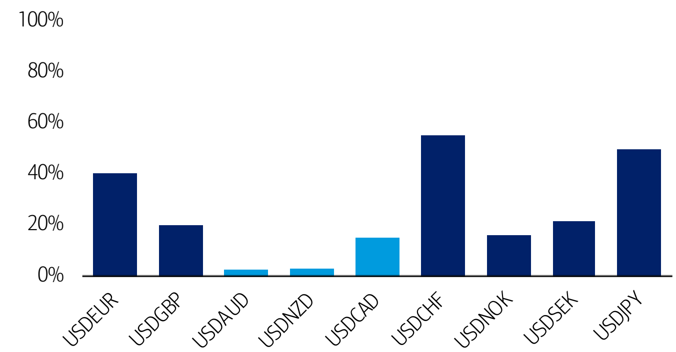
**Exhibit 8: Risk reversals are most stretched for USD puts vs AUD, NZD and CAD**
10y percentile of 3m 25d risk reversals (as % of atm vol) for USD vs G10 FX




**Source:** BofA Global Research, Bloomberg
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Alternatively, investors who see the potential for a higher magnitude near-term USD bounce may consider owning a more significant tail through net zero delta OTMF USD call spreads (e.g. own more than 1x notional of 10df USD call funded by 1x notional of 25df USD call), while limiting the downside on the position.

## Scenario 2: weak economic data surprise outside of US

In addition to an equity-induced USD rally, the USD may also rally in scenarios of material deterioration of macroeconomic data outside of the US, in a potential replay of the 3Q23 dynamic. The Q2 US GDP upside surprise on 27 Jul '23 triggered a 2-month USD rally in Aug-Sep '23. The economic backdrop was in favor of the USD as the US was seen as having growth re-acceleration while the global economy outside of the US continued to slow down. While we do not expect the US economy to continue performing at an above-trend pace this year, the risk of data worsening earlier and by more than our baseline outside of the US cannot be ignored. This would still lead to widening growth differentials with the US like in 3Q23 and as a result lead to demand for the USD on US growth outperformance.

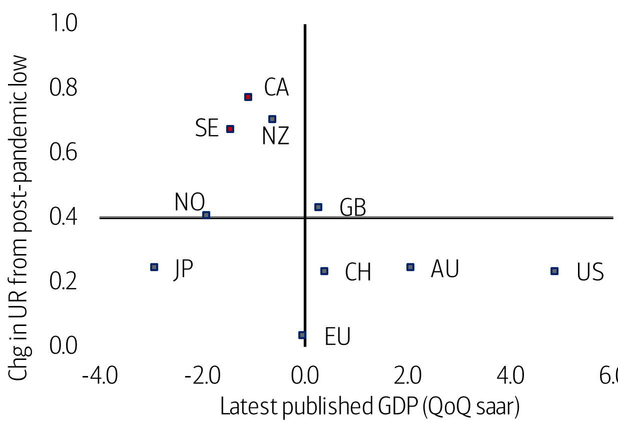
### Swedish and Canadian data most vulnerable in G10

Unlike the first scenario, the USD rally in this scenario would likely be more idiosyncratic than broad-based. In G10, Canada and Sweden appear to be the most vulnerable. In '23, Canada, Sweden, and New Zealand saw above average pick-up in unemployment rate (UR) and negative growth (see Exhibit 9). Looking ahead into '24, consensus forecast continues to anticipate further above average UR increases and below average annual growth for Sweden and Canada (see Exhibit 10).

While the US already has better economic conditions than its G10 peers, the magnitude has not yet warranted cyclical decoupling. The rates market currently prices broad-based declines in policy rates for G10 central banks over the next year with similarly shaped rate paths. For now, pricing is the most aggressive for Fed cuts, more so due to the dovish Fed communication compared to other central banks. Other currencies could weaken vs the USD, should rate cut pricing for the respective central banks increase on the back of negative economic data surprises.

**Exhibit 9: Growth and employment data mix have been the weakest for New Zealand, Sweden and Canada in G10**

Latest quarterly GDP vs chg in unemployment rate from post-pandemic low




**Source:** BofA Global Research, Bloomberg

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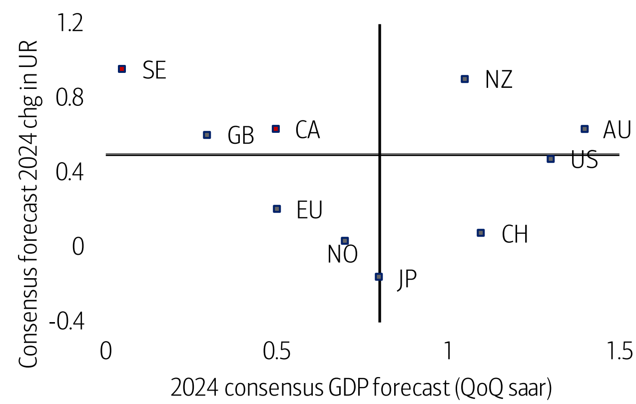
**Exhibit 10: 2024 Consensus outlook is most bearish on growth and employment for Sweden, Canada, and UK in G10**

'24 Consensus GDP forecast vs consensus forecast implied chg in UR




**Source:** BofA Global Research, Bloomberg

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### Cheapen long-dated USD puts with calendar spread structure

In the FX Quant/Vol Year Ahead from 21 Nov '23, we discussed owning long-dated USD puts outright as our preferred options structure to express the bearish USD core view for '24. For investors that subscribe to the idea that a near-term USD rally could take place due to foreign economic data weakness, before further selloff, calendar spreads can be used to cheapen the premium of owning longer-dated USD puts. For example, a 3m9m ATMF USDCAD calendar put spread (sell 3m USDCAD put and buy 9m USDCAD put) would offer around 50% initial premium saving compared to owning a 9m USDCAD put outright. We also observe similar magnitude of cost-saving in other USD/G10 pairs like USD/SEK. We especially like the USDCAD structure because it is in-line with our latest CAD fundamental view (see CAD Year Ahead from 5 Jan '24), which sees 1.34-1.35 as the short-term fair value range and anticipates more backloaded CAD appreciation in '24. As for the SEK, our European colleagues currently prefer to express the bearish SEK view in relative value form against GBP (FX Alpha: 12 January 2024). The risk to this scenario would be resilient non-US economic data and a USD sell off earlier vs later in '24.

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