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Liquid Insight

Debt ceiling anxiety in G10 FX

25 May 2023

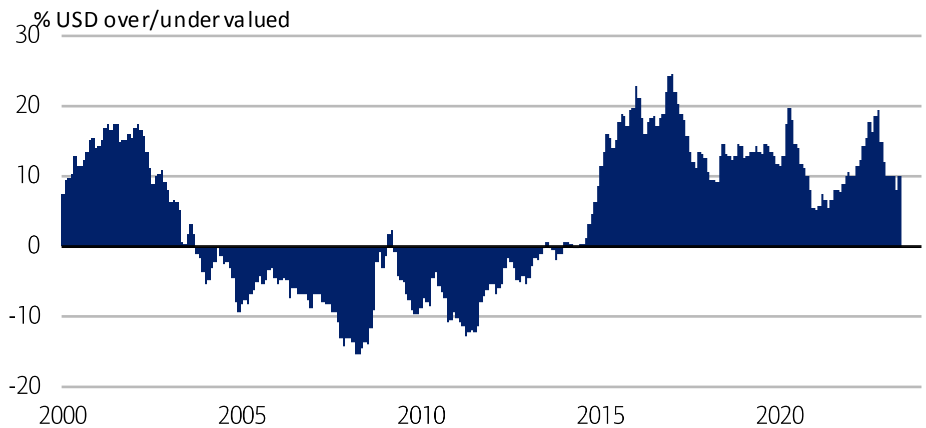
Rates and Currencies Research
Global

Key takeaways

- While markets grow more anxious over the debt limit ceiling, high inflation and the possibility of recession persist.
- We continue to expect some near-term USD strength, given the persistence of inflation and market debt-ceiling concerns.
- Our EUR-USD view stays the same with an end-2023 forecast of 1.10, and most G10 FX forecasts also stay unchanged as well.

By John Shin, Alex Cohen and Athanasios Vamvakidis

Chart of the day: USD is roughly 10 pct overvalued compared to the past decade
The overvalued USD guides over longer-term views of dollar downside



Source: Bank of Internatioanl Settlements, Bloomberg, and BofA Global Research

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Queasy start to summer

The approaching start to Summer has been filled with increasing market anxiety as the debt limit ceiling approaches. However, core issues around markets persist in terms of high inflation and the likelihood of a recession in the second half of the year. Consequently, in G10 FX, we hold our general USD view unchanged (see the World at a Glance, "Debt Ceiling Anxiety", 24-May-2023), including an end-year EUR-USD forecast of 1.10. In general, we see USD broadly overvalued (see the Chart of the Day; also see our FX Viewpoint, "Updating G10 FX Equilibrium", 20-Apr-2023), and our longer-term views reflect such valuation. But in the short run, we are more USD-positive, focusing on both EUR and JPY given the likelihood of the Fed staying on hold, and risk-off worries around the debt ceiling.

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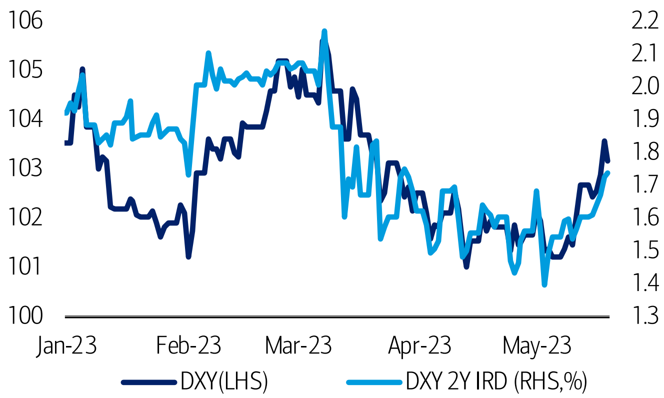
Are we sure we've reached terminal?

April's range-bound trading continued throughout early May, though upside US data, and signs of economic softness abroad has propelled the dollar in recent weeks. The May FOMC meeting sent a signal to the market that they see monetary policy as at or near restrictive levels, causing many to believe that the terminal rate has been reached. Chair Powell's messaging reinforced a "meeting-by-meeting" approach and some bias towards additional hikes if warranted by the incoming data. Subsequent US dataflow, in aggregate, has pointed to continued economic resiliency, and some other Fed officials have recently spoken about the prospect for additional hikes. This, coupled with softening economic data out of Europe and China has supported the dollar, bringing the Bloomberg Dollar Index to its highest level in two months. The moves have mainly tracked well with US-foreign interest rate differentials (Exhibit 1).

Exhibit 1: DXY & 2-Y rate differentials
Dollar breakout tracking with widening rate differentials



Source: Bloomberg and BofA Global Research

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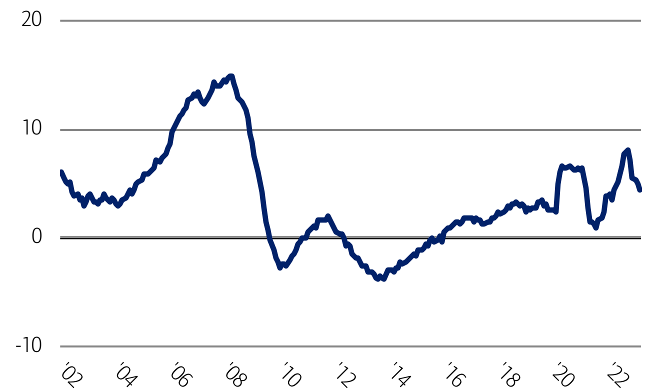
Exhibit 2: Eurozone credit growth to non-financial corporates
Eurozone credit growth is slowing



Source: ECB and BofA Global Research

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US debt ceiling

Still, for all the longer-term issues confronting both the US and global economies, the debt ceiling is dominating market attention. With the June 1 "X-date" fast approaching, how the debt ceiling will specifically play out is not straightforward. In previous episodes, the USD was generally stable ahead of resolution. If when a deal is struck, we see more possible crosscurrents impacting the USD. Any deal will likely result in a surge in Treasury bill issuance, putting upward pressure on money market rates. This should be near-term USD supportive, all else equal. However, in the medium/longer term, expected fiscal contraction related to the spending portion of the agreement could point to lower US policy rates further out, serving as a USD headwind.

Beyond that, uncertainty over how the economy will land keeps open a wide range of outcomes. Nevertheless, markets remain relatively complacent. While our base-case calls for a last-minute resolution, the tail risk of passing the X-date could still materialize. The market appears optimistic given recent constructive headlines. (For more, see FX Viewpoint, "Two-sided FX risk from the debt ceiling", 19 May 2023)

Looking for weak short term for EUR before sustained rally

The EUR has weakened in May and more generally has been unable to sustain a rally so far this year. It has been in a range, after strengthening from a very weak level at the end of last year. As we argued last month, a lot of good news were already in the price, such as the hawkish ECB, the drop in energy prices and China's reopening. Weak data in China recently disappointed strong expectations about the recovery, which together with resilient US data and mixed Eurozone data (Exhibit 2) weighed on the EUR.

Although ECB communication remains hawkish, slowing the pace of hikes has not helped, while the market is already pricing two more hikes. Global data are still consistent with a non-landing scenario, while core inflation remains sticky in most G10 economies, particularly in the Eurozone, point to high uncertainty about the path towards the inflation target. We also disagree with market pricing of an early and aggressive easing cycle in most of the G10 economies starting in the second half of this year. All these forces, along with a possible risk-off event from the debt ceiling, could push the EUR even lower in the short term. We continue to remain positive longer term, as the EUR remains historically weak and below equilibrium estimates, but a more sustained rally needs landing of the economy first.

Forecasts: mostly unchanged over the past month

Although EURUSD has spent most of H1 above our 1.05 forecast, we are not far and we stick to it. We also keep our end-year 2023 1.10 and 2024 1.15 forecasts. We reiterate that the timing of this path is uncertain and depends on crucial fundamentals such as the stickiness of Eurozone inflation vs the rest of G10 and the kind of landing towards the inflation target.

We maintain our current forecasts for the USD (Exhibit 3) to be broadly supported in the near-term, but with medium-term softening. Since last month, the only forecast change we have made in G10 FX was to modestly push up USD-JPY (for more on our yen forecast revision, see FX Watch, "Patient BOJ = greenlight for yen-carry trade", 01 May 2023). We do not have any other changes in our FX forecasts, including both European FX as well as the Dollar bloc. We have long argued that sticky inflation will keep central banks with a hawkish bias, and the Fed is no exception. Despite incremental improvements on inflation readings, we are still ways away from 2%. Later in the year and into 2024, we expect the dollar to gradually begin depreciating back towards equilibrium.

Risks: waiting for landing

Aside from the debt ceiling, in terms of risks, we still worry that the current non-landing scenario is not sustainable, while we believe the consensus soft landing is not realistic. In particular for the EUR, how the European and more broadly the global economy land to the inflation target from well above will also determine the FX path. In addition, China's recovery, energy prices and the war in Ukraine are also USD risks.

Exhibit 3: G10 FX Forecasts

Our forecast for EUR-USD remains 1.10 for the end of the year

	Spot	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
G3								
EUR-USD	1.08	1.05	1.07	1.10	1.10	1.10	1.15	1.15
USD-JPY	139	138	143	140	135	132	125	125
EUR-JPY	149	145	153	154	149	145	144	144
Dollar Bloc								
USD-CAD	1.35	1.34	1.30	1.28	1.25	1.25	1.25	1.25
AUD-USD	0.66	0.68	0.72	0.74	0.76	0.76	0.76	0.76
NZD-USD	0.62	0.62	0.64	0.66	0.67	0.67	0.67	0.67
Europe								
EUR-GBP	0.87	0.89	0.90	0.91	0.91	0.91	0.91	0.91
GBP-USD	1.24	1.18	1.19	1.21	1.21	1.21	1.26	1.26
EUR-CHF	0.97	0.98	0.98	0.98	0.99	0.99	1.00	1.00
USD-CHF	0.90	0.93	0.92	0.89	0.90	0.90	0.87	0.87
EUR-SEK	11.44	11.40	11.50	11.00	10.70	10.60	10.50	10.30
USD-SEK	10.62	10.86	10.75	10.00	9.73	9.64	9.13	8.96
EUR-NOK	11.81	11.20	10.90	10.60	10.40	10.40	10.20	10.00
USD-NOK	10.96	10.67	10.19	9.64	9.45	9.45	8.87	8.70

Forecast as of May-23-2023. Spot exchange rate as of May-23-2023. The left of the currency pair is the denominator of the exchange rate. **Source:** Bloomberg and BofA Global Research

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- A different May narrative, **Global FX Weekly**, 19 May 2023
- The Godot recession**, Global Rates Weekly**, 19 May 2023
- Behind the latest USD rally, **Liquid Cross Border Flows**, 15 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: A different May narrative 19 May 2023

Global Rates Weekly: The Godot recession 19 May 2023

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