

Liquid Insight

Some overshoots greater than others

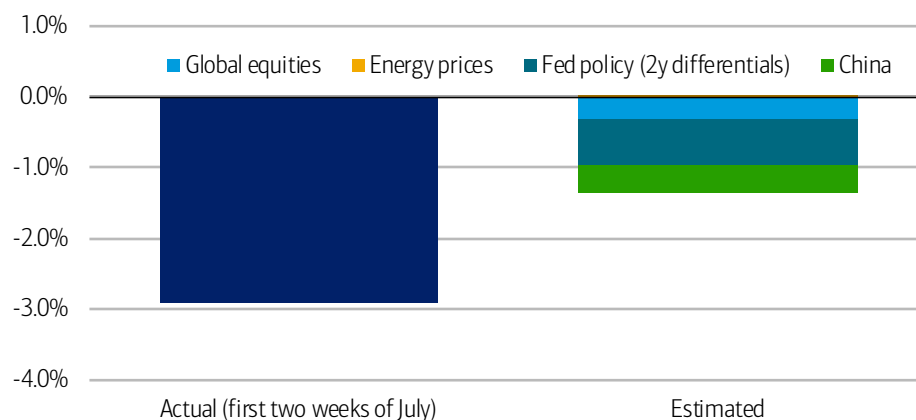
Key takeaways

- DXY depreciation larger than underlying drivers imply, but largely attributable to positioning and technical breaks.
- NOK and JPY rallies have exceeded expected moves - if FX volatility stays low, JPY underperformance likely to resume.
- For investors expecting USD weakness to continue, CAD offers the best scope for catch up within our PCA framework.

By Adarsh Sinha

Chart of the Day: DXY performance – first two weeks of July

Vs. estimated move based on key drivers



Source: Bloomberg. Note: China - reflation PCA, Fed policy - weighted 2y differentials, Energy prices - BCOMEN Index, Global equities - MSCI World

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Looking beyond DXY overshoot

The actual depreciation in the DXY dollar index has meaningfully exceeded that implied by its underlying drivers, albeit less so when looking at our agnostic PCA framework. These overshoots can typically be attributed to stretched positioning and sentiment, as well as technical breaks, all of which likely played a role in the broader USD sell-off recently. In terms of outliers, we show NOK and JPY appreciation has exceeded its expected moves. We expect JPY underperformance to resume once the dust settles and assuming FX volatility stays low through the summer. For USD bears, CAD offers scope for catch up to its estimated move.

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Rates and Currencies Research
GlobalGlobal Rates & Currencies Research
MLI (UK)

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

See Team Page for List of Analysts

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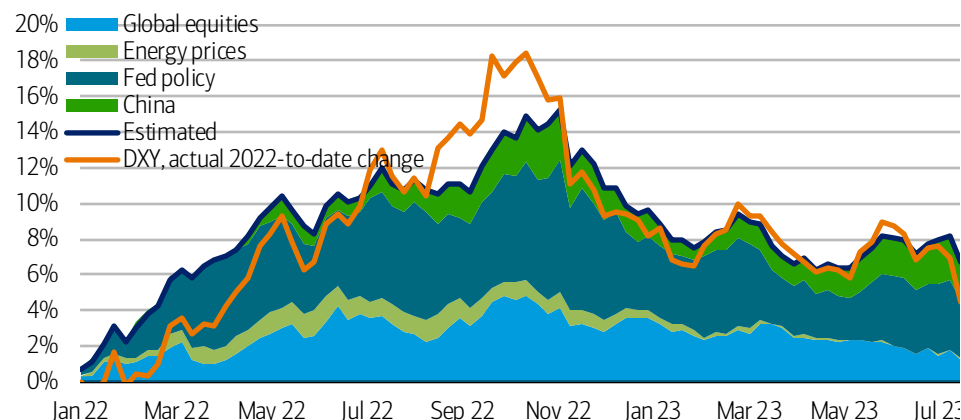
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DXY has been well behaved over the long term...

Since 2022 we have run a simple out-of-sample exercise as a cross check for whether the DXY level is consistent with its external macro drivers. This is based on a regression of weekly changes of an DXY index (excluding CNY) on 2y rate differentials, MSCI World, energy prices and China reflation sentiment. Exhibit 2 below shows the long term (2022-to-date) move can be almost entirely attributed to these drivers.

Exhibit 1: DXY dollar index - actual vs. estimated (& contributions) based on key drivers

DXY has been well behaved over the long term (Jan 2022-to-date)



Source: Bloomberg, Note: China - reflation PCA, Fed policy - weighted 2y differentials, Energy prices - BCOMEN Index, Global equities - MSCI World

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... but less so over past two weeks

However, the contributions during the sharp USD sell off over the first two weeks of July (Chart of the Day, front page) show the actual depreciation in DXY (~2.9%) has meaningfully exceeded that implied by its underlying drivers (~1.3%). These overshoots can typically be attributed to stretched positioning and sentiment, as well as technical breaks, all of which likely played a role in the broader USD sell-off recently ([Crushing the dollar 12 July 2023](#)).

For instance, hedge fund positioning from our flows at the beginning of July (see our report, [Liquid Cross Border Flows 03 July 2023](#)) at least partly explain cross-sectional FX moves month-to-date. Exhibit 2 shows the outperformance of NZD and SEK for instance can be attributed to relative positioning. While NOK strength looks “out of whack” relative to positioning, it was likely amplified by clear technical breaks (vs. EUR), as well as higher-than-expected CPI inflation. On the flip side, CAD appreciation was likely constrained by greater positioning.

An agnostic approach suggests less DXY overshoot...

In contrast to the above approach, we also make a more agnostic assessment of recent FX moves. Specifically, we update our principal component analysis (PCA) approach to identify drivers of G10 FX. We apply PCA to G10 pairs (vs. USD), extracting three components that explain the bulk (94%) of the co-movement between the exchange rates. To the extent these are “drivers” affecting all currencies, we assume they capture external factors. Looking at simple correlations of these components with market prices allows us to infer the underlying fundamental drivers, which we have previously identified as the US dollar, risk and rates.

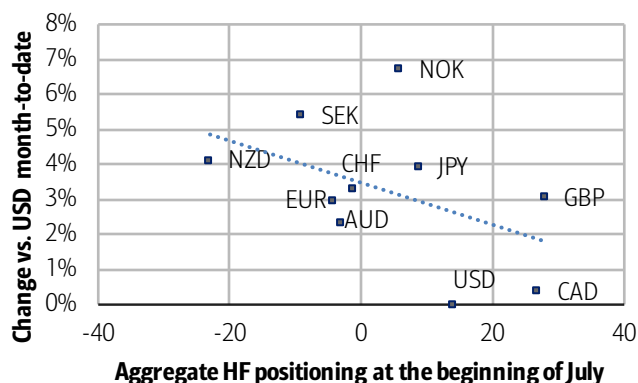
... but other G10 currency disparities – NOK, JPY & CAD

Exhibit 4 compares the actual vs. estimated performances of G10 pairs in 2023 year-to-date, using weekly data (until 21 April). This period captures a wide range of cross-currents for the USD. The estimated performance is out-of-sample, based on individual betas of each G10 pair (as well as the DXY index) to the three PCA components since 2010. We highlight the following key takeaways.

- There is less evidence of DXY overshoot according to this methodology but this is largely by construction. Since the PCA factors are derived from G10 FX pairs, they imply a larger move in the underlying drivers than actually observed, especially for the risk factor.
- NOK and JPY have exceeded the estimated moves the most. We discussed the reasons for NOK strength above. For JPY, the sharp appreciation was likely driven by CTA position unwinds, as flagged in [Systematic Flows Monitor 07 July 2023](#). If FX volatility stays low over the summer, we expect JPY underperformance to resume vs. other currencies given attractive vol-adjusted carry associated with JPY funding.
- CAD stands out as underperforming its estimated move – positioning as shown above partly explains this. If US dollar weakness continues, USD/CAD is an attractive short especially if it breaks below year-to-date lows. Medium-term we are more concerned about the risk of hard landing in Canada and potential negative spillover to the currency ([Re-assessing our bullish CAD view 12 July 2023](#)).

Exhibit 2: July month-to-date G10 FX performance vs. hedge fund positioning

Outperformance of NZD and SEK can be attributed to relative positioning

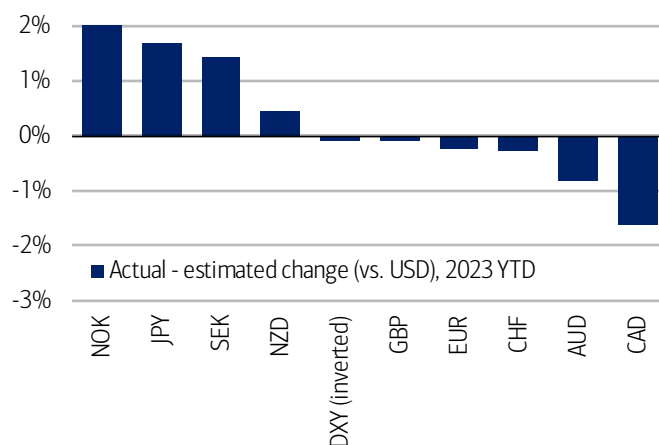


Source: Bloomberg

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Exhibit 3: Actual vs. PCA-based changes (vs. USD), first two weeks of July 2023

Most currencies within +/- 1 pp of estimated performance, except NOK, JPY and CAD



Source: Bloomberg. Note: PCA factors extracted from G10 pairs vs. USD

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- [Price is right](#) **Global Rates Weekly**, 14 July 2023
- [To carry or not](#), **Liquid Cross Border Flows**, 10 July 2023

Rates, FX & EM trades for 2023

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[Global FX weekly: Carry resurrection; the reports of its death were greatly exaggerated](#)
14 July 2023

[Global Rates Weekly: Price is right](#) 14 July 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BoFA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BoFA Japan
+81 3 6225 8515
shusuke.yamada@bofa.com

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