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Liquid Insight

Respect the dots but don't dwell on it

10 July 2023

Rates and Currencies Research
Global

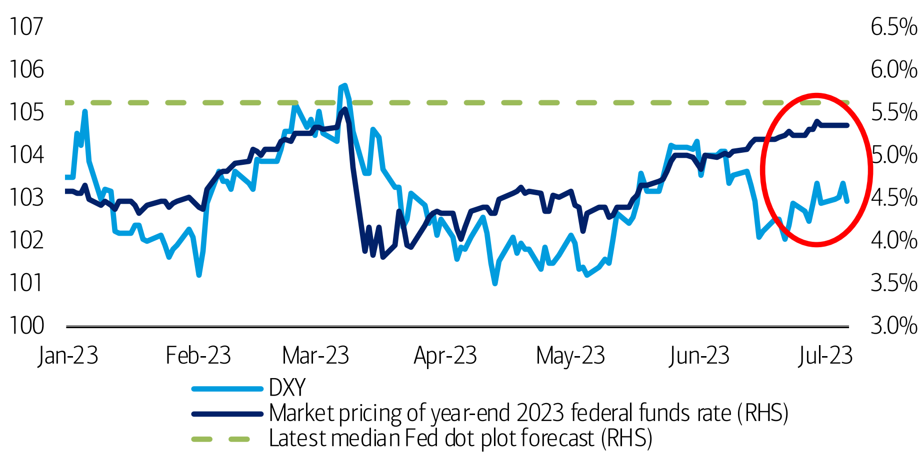
Key takeaways

- Before 2022, Fed dot plot tended to overestimate year-end FF rate while futures market tended to underestimate.
- Our forecast is in-line with the Fed's view for 2023, but leans more towards market pricing for 2024.
- We see a short-term USD bounce and medium-term weaker USD; short USD calls on rallies to position for medium-term downtrend.

By Vadim Iaralov/Howard Du

Chart of the Day: DXY vs 2023 year-end forecasts of federal funds rate

Rates market pricing for year-end 2023 federal funds rate is converging to the Fed's dot plot forecast, supporting our view of a short-term USD bounce back



Source: BofA Global Research, Bloomberg

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Implications of year-end FF rate forecasts for the USD

Before 2022, the Fed's median dot tended to overestimate current year-end federal funds target rate while the futures market had more often underestimated. We believe this is due to market's inclination to price-in more risk premium of a growth downturn over the past decade. However, both the Fed and market had overestimated year-end rate level in 2019 and underestimated in 2022. Our current economic forecast is in-line with the Fed's dot plot forecast for rest of 2023 as we see federal funds target rate upper bound reaching 5.75% by year-end. For 2024, our projection is closer to current market pricing. In the FX space, we expect a short-term USD bounce in the summer and more material USD sell-off to take place in 2024. We prefer shorting long-dated out-of-money USD calls on spot rallies to participate in the choppy USD downtrend for the medium to long-term. The risk is a sustained rise in FX vol amid persistent USD rally.

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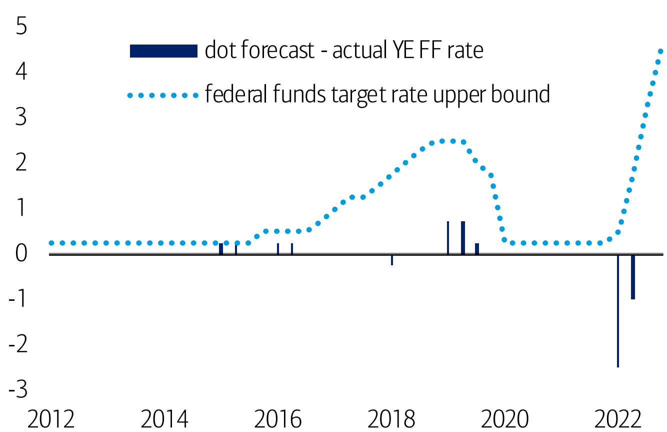
The usefulness of Fed's dot plot

Since its emergence in 2012, the Fed dot plot has been a useful tool for the Federal Reserve to communicate forward guidance with market participants. In the latest June 2023 SEP (Summary of Economic Projections), the dot plot median shows the Fed expect two more rate hikes for rest of the year, piquing investor attention. At the same time, the federal funds futures market sees year-end federal funds rate staying around a 5.25-5.50% range, slightly lower than Fed's guidance. In this note, we examine how Fed dot plots and market pricing have fared vs actual year-end federal funds rate and discuss any implications for the FX market in 2023.

Exhibit 1: Before 2022, Fed has had more of a tendency to overestimate year-end rate level

Current year-end median dot plot forecast for FOMC meetings since 2012 vs actual year-end federal funds target rate



Source: Boafo Global Research, Bloomberg. The Federal Reserve. A value above 0 means the Fed overestimated year-end federal funds target rate and a value below 0 means the Fed underestimated year-end federal funds target rate.

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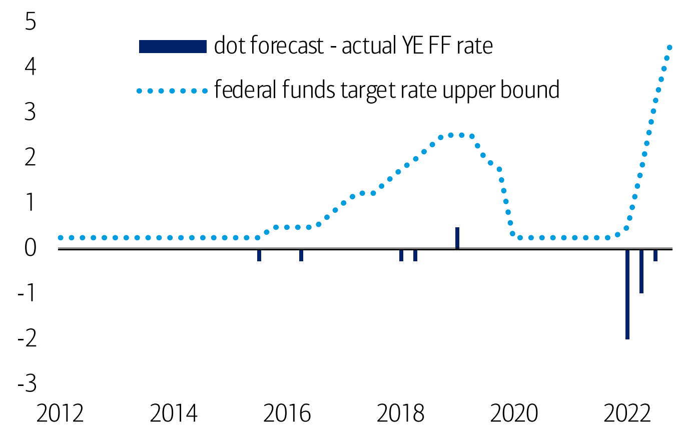
Exhibit 2: Market had often underestimated year-end rate level

Federal funds futures pricing for year-end vs actual year-end federal funds target rate



Source: BofA Global Research, Bloomberg. A value above 0 means the market overestimated year-end federal funds target rate and a value below 0 means the market underestimated year-end federal funds target rate.

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Market tends to underestimate year-end rate level vs Fed dot plot

Exhibit 1 shows the spread between median dot plot forecast (rounded up to nearest 0.25% increment) for current year-end and actual year-end federal funds rate upper bound. Before 2022, the Fed had a slight bias to overestimate year-end federal funds rate but had significantly underestimated how fast rates would rise in 2022.

Exhibit 2 computes the same spread between federal funds futures pricing for current year end (rounded up to nearest 0.25% increment) and actual year-end federal funds rate upper bound. Compared to the median Fed dot plot forecast, the market historically has tended to underestimate year-end rate level. In our view, this is largely due to the market pricing-in a risk premium for the tail risk of downside growth shock.

Each dot represents each Fed official's base case for the federal funds rate. The median dot is effectively the median base case for the committee. By contrast, markets are paid to take risks and have to consider tail risks and market expectation averages across a variety of outcomes. If a severe downturn is possible but unlikely, it would skew market's estimate lower, but figure less into the Fed's median dot.

After the Fed had embarked on its first post-GFC hiking cycle in Dec 2015, the Fed had expected to hike rates twice in 2016. But the market expectation was more muted, sensing downside risks around the corner. As it turned out, the Fed only hiked once in 2016 (Dec) after a series of unexpected shocks had materialized: leading indicators troughed in Q1 2016 amid fears of China slowdown, Brexit surprised in Q2, and a slower-than-expected labor market recovery did not support a hike in Q3. In 2018, market's worry of growth downside started to emerge amid ongoing US-China trade war tension. The risk had partly materialized by end of 2018 with the US stock market experiencing a 19% decline in Q4 of that year.

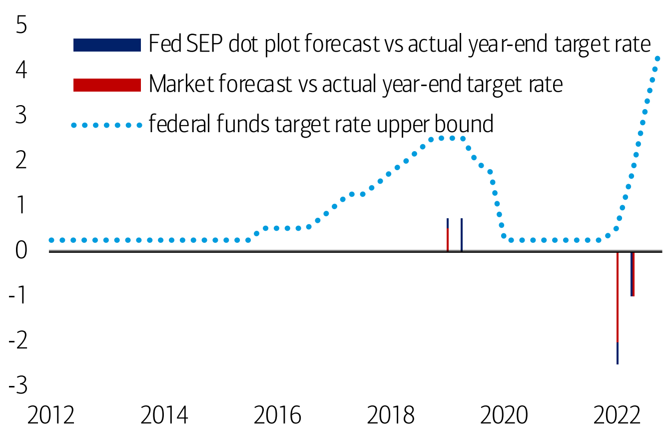
Both market and the Fed have been wrong in 2019 and 2022

If one treats 25 bp discrepancy between projections and actual year-end rate levels as an acceptable range for error, Exhibit 3 combines the result from Exhibit 1 and Exhibit 2 side-by-side, but removes any spreads that were 25 bp or less. Both the Fed and market had overestimated year-end rate level in 2019 and underestimated year-end rate level in 2022. Based on the historical findings, we believe it is reasonable that market sees slightly lower year-end rate level than the Fed. The risk is for the economy to evolve into either a more stagflationary regime or a fully-fledged global recession where both the Fed and market projections turn out to be wrong.

For now, our economists' view (US Economic Viewpoint: 14 June 2023) is in-line with the Fed's projection for 2023 but lean closer to market pricing for 2024. In our baseline view, we see 2 more Fed rate hikes in 2023, bringing year-end federal funds target upper bound to 5.75%. But for 2024, we expect the Fed to cut rate to 4.25%, vs 4.75% in the latest Fed dot plot forecast and market pricing of around 4.25%.

Exhibit 3: Both Fed and the market overestimated year-end rate in 2019 and underestimated year-end rate in 2022

Fed dot plot forecasts and market-traded futures forecasts that differed by more than 25 bp vs actual year-end federal funds target rates



Source: BofA Global Research, Bloomberg. The Federal Reserve. A value above 0 means overestimation vs actual year-end federal funds target rate and a value below 0 means underestimation vs year-end federal funds target rate.

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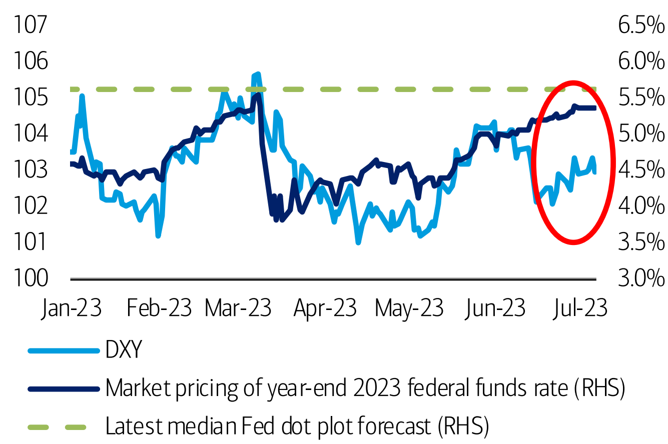
Exhibit 4: Current market pricing for year-end federal funds rate is only slightly below Fed projection, supporting short-term USD bounce

Latest market pricing of year-end 2023 federal funds rate vs latest median Fed dot forecast, plotted against the DXY index



Source: BofA Global Research, Bloomberg

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Short-term USD rally and more material USD weakness in 2024

Shortly after the March regional bank stress in the US, market pricing for year-end rate level sharply declined from 5.6% to 3.9% (Exhibit 4). As rates market pricing reverberated closer to the Fed's projection, the USD also rallied back in May.

Into June, rates market had continued to move toward Fed's projection, but the USD's path diverged (Exhibit 4). In our view, improvement in broad risk sentiment and bearish June seasonal factors were the drivers for weaker USD over the past few weeks, but this short-term bearish USD momentum is fading (FX quant signals to end H1, 26 June 2023). The DXY had been above a 104-handle when rates market last priced year-end rate level above 5.25, so we would argue the current "higher for longer" forward guidance still supports a short-term USD bounce back.

For now, our official EUR/USD forecast is 1.05 for rest of the year. We expect more material USD downtrend to take place in H1 2024 when indications of a growth landing become more apparent. However, the exact timing is highly uncertain and data dependent. As a result, we like shorting long-dated out-of-money USD calls on spot rallies as a way to participate in the choppy USD downtrend for the medium to long-term. The risk is a sharper than expected growth shock in the US, turning into a global recession and the USD broadly appreciates on rising demand for haven currencies.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Data points to more divergence ahead **Global FX Weekly**, 7 July 2023
- Break out the shorts **Global Rates Weekly**, 7 July 2023
- Ahead of H2, **Liquid Cross Border Flows**, 3 July 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: Data points to more divergence ahead 07 July 2023

Global Rates Weekly: Break out the shorts 07 July 2023

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