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Liquid Insight

Jittery landings in G10 FX

22 November 2023

Rates and Currencies Research
Global

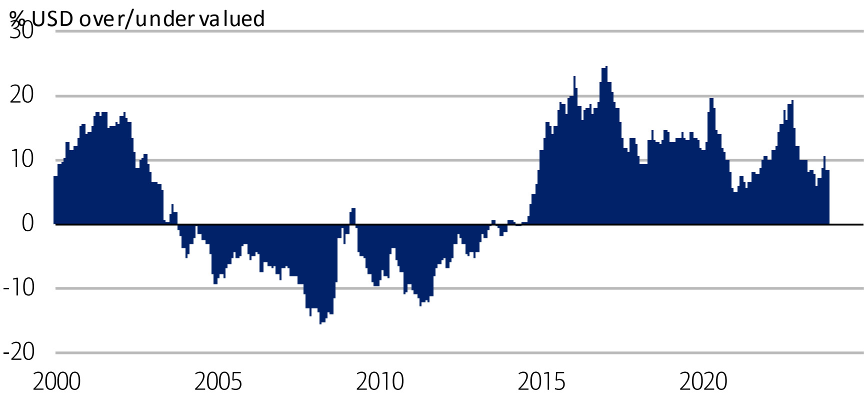
Key takeaways

- We expect the USD to soften against G10 FX in 2024, led by our forecast for EUR-USD of 1.15 for the end of the year.
- Our EUR, JPY and AUD forecast profiles are unchanged, we have recent revisions elsewhere in our Europe and Dollar Bloc views.
- A Fed cutting rates as the economy softens and inflation drifts lower should help reverse previous USD overvaluation.

By John Shin, Athanasios Vamakidis and Alex Cohen

Chart of the day: USD roughly 5-10% overvalued into 2024

USD Real effective exchange rate compared to previous ten years



Source: Bloomberg, BIS and BofA Global Research

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Stretched USD into 2024

We expect a modestly weaker USD next year. Relatively stronger US macro data have helped avoid more difficult choices between fighting inflation and staving off macro weakness. But as central banks, especially the Fed, reverse course in 2024 and generally begin to cut rates, USD should wind up moving away from such strong levels and revert back towards longer-term equilibrium. Consequently, we continue to hold our core macro views of expecting EUR-USD to end 2024 at 1.15 and for USD-JPY to be at 142. That said, we have made revisions throughout G10, such as raising our USD-CAD and EUR-GBP profiles (see the World at a Glance, "2024 – The Year Ahead: jittery landing", 19 Nov 2023). And markets remain deeply concerned whether policymakers will be able to successfully continue to both reduce inflation and avoid a sharper downturn.

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USD: the tide is turning, travelling towards equilibrium in 2024

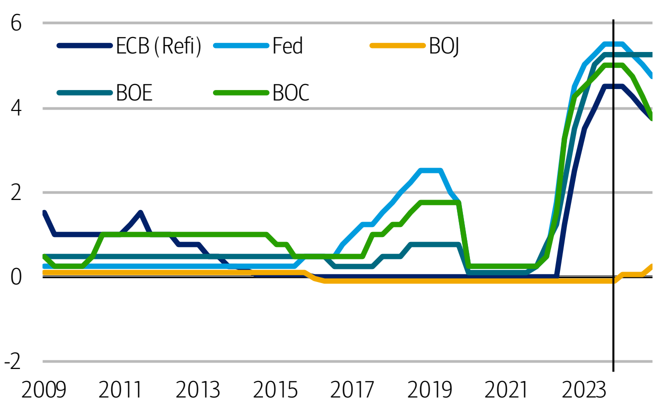
As the USD looks to end 2023 on the back foot against most G10 currencies, we see 2024 as the year it can start to adjust broadly lower towards equilibrium (see FX Viewpoint, "G10 FX Year Ahead: The year of the landing", 20 Nov 2023). While we still envision the US performing relatively well next year vis-à-vis other major economies, the prospect of an eventual economic landing and corresponding Fed easing, even alongside easing elsewhere, should provide broad relief to currencies across the globe.

For example, in our base-case scenario, we see both the Fed and ECB ultimately easing by similar amounts (Exhibit 1; see Global Economics, "Year Ahead 2024: Growing apart, cutting together", 19 Nov 2023). Fed Chariman Powell has a variety of different policy choices to choose from and objectives to balance, but ultimately is likely to normalize rates towards the downside, albeit gradually.

Thus, while we expect global growth to remain tepid overall, the continuation of dis-inflation globally should diminish the relative real-rate advantage of the US, serving as a USD headwind. Higher inflation has perversely been advantageous for USD, with the converse of cooler inflation being the key FX driver for sizable chunks of the past year (Exhibit 2). Interestingly, however, we see this base case as the most pessimistic with regards to our USD forecasts, with other individual alternative scenarios producing either more modest USD depreciation, or even further appreciation.

Exhibit 1: Central bank mixed bag

We expect a mix of policy responses in 2024 among the G5 banks



Source: Bloomberg and BofA Global Research

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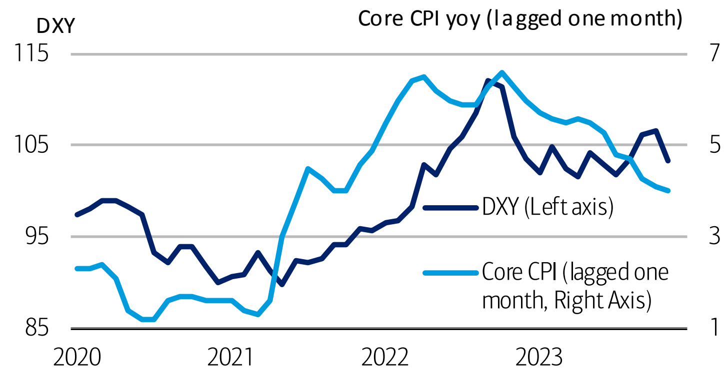
Exhibit 2: DXY and US Core CPI

Disinflationary trends should help guide USD lower



Source: Bloomberg and BofA Global Research

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EUR: Pyrrhic victory stronger, but chiefly because of weaker USD

We expect a stronger EUR for next year, but primarily against the USD. The EUR NEER (nominal effective exchange rate) is already near an all-time high. The EUR REER (real effective exchange rate) is close to its historic average. The EUR is historically strong vs. JPY, GBP and the Scandies, and it is hard to argue for much further strength. The EUR is historically weak only vs. the USD and the CHF. We expect CHF to remain resilient for as long as the Swiss National Bank (SNB) continues to shrink its balance sheet.

However, EURUSD weakness this year has been primarily because of US decoupling, which should start reversing if US growth slows. Although we still expect Eurozone growth to remain weak and below US growth next year, we forecast a smaller gap, which in turn should support EURUSD from an undervalued level (Exhibit 3). Although our baseline expects both the ECB and the Fed to start cutting rates in June and at the same pace of only once a quarter, we would expect Fed cuts to ultimately matter more for FX, particularly given EURUSD undervaluation.

Forecasts: still looking for core USD gradual depreciation vs EUR and JPY...
Our 2024 baseline scenario sees USD weakenin. For next year, we have consistently been expecting EURUSD to gradually appreciate to 1.15 by end-2024, and we stick with this. Unsurprisingly, most of our G10 FX outlook generally tends to follow EUR-USD (see Exhibit 7 for our full forecast table (see the World at a Glance, "2024 – The Year Ahead: jittery landing", 19 Nov 2023).

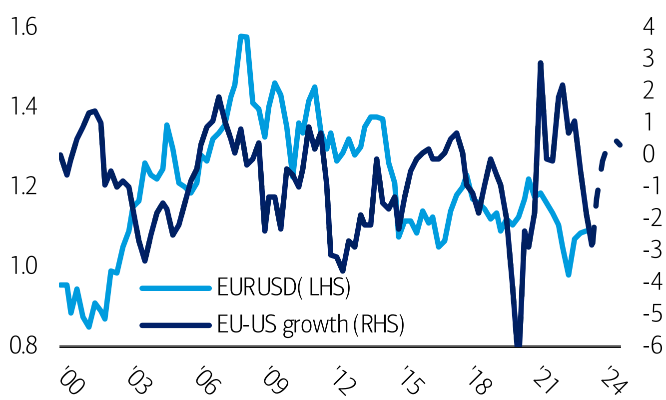
Similarly, for the longer term, in 2025, we expect EURUSD to reach 1.20, which is consistent with our long-term equilibrium estimates. We are above the consensus of 1.11 and 1.15 for 2023 and 2024 respectively, while we were below the consensus this year. This assumes an economic landing in the US, with the US economy recoupling to a degree with the rest of the world.

For USDJPY, we also expect USD at 142 (after peaking at 155 in Q1; see Exhibit 4), especially as the Bank of Japan appears to be nearing the end of Negative Interest Rate Policy (NIRP) and US-Japan monetary policy move in a convergent direction. Both of these forecasts are unchanged from our previous outlook. We also left our AUD-USD forecast the same as well, looking for upside by the end of 2024 as well.

... revisions elsewhere in G10, highlighted by GBP and CAD
We did make forecast revisions throughout the remainer of G10. In particular, we raised our USD-CAD profile, although we still look for Canadian Dollar upside, but not as much as before, expecting 1.30 for end-2024 compared to 1.26 prevously. We also raised our EUR-GBP profile with an end-year forecast of 0.88 from 0.85, which mechanically also lowers the cable forecast as well, with a new end-year forecast of 1.31.

Similarly, we also lowered our NZD-USD profile but still look for USD weakness, and also made adjustments to our direct EUR-CHF and EUR-Scandies forecasts as well.

Exhibit 3: EURUSD and growth differentials
Weaker US growth next year should allow stronger EURUSD



Source: Bloomberg and BofA Global Research

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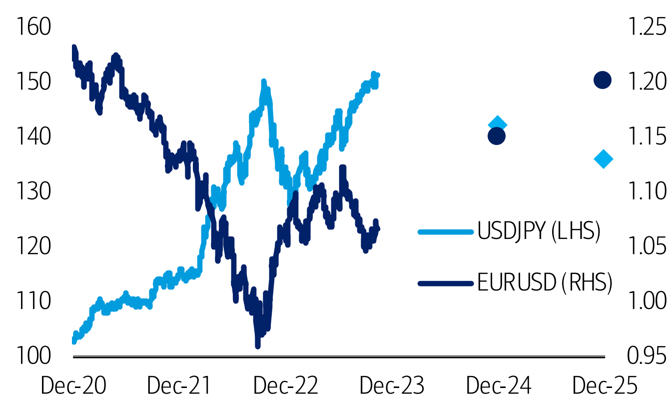
Exhibit 4: EURUSD and USDJPY and 2024 & 2025 YE Forecasts
Weaker US growth next year should allow stronger EURUSD



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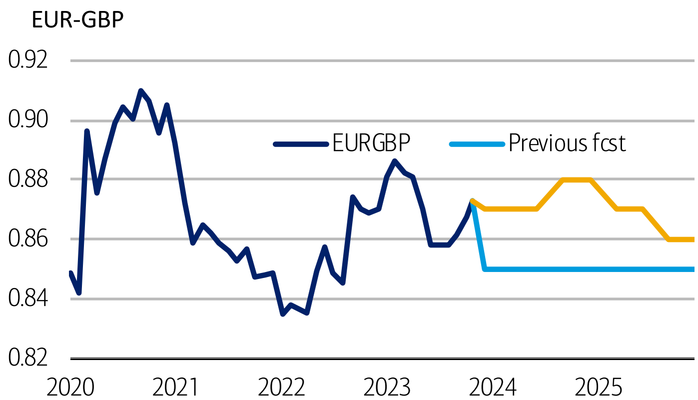
Risks: alternative scenarios generally more USD supportive...
While we see our base-case scenario as the most likely outcome compared to the alternatives, there are several "known unknown" scenarios that in aggregate imply a notable risk to our base-case. We consider an upside growth/inflation driven rate shock originating in the US, a supply-driven upward oil price shock, and a downward growth shock from China as the most visible among them. Should any of these develop, our core USD view would most likely be challenged. In these cases, the current US growth and rate advantage would potentially be accentuated, serving as a renewed tailwind for the USD.

Exhibit 5: G10 FX revisions -- GBP
Among elsewhere in G10, we revise EUR-GBP higher



Source: BIS and Bloomberg and BofA Global Research

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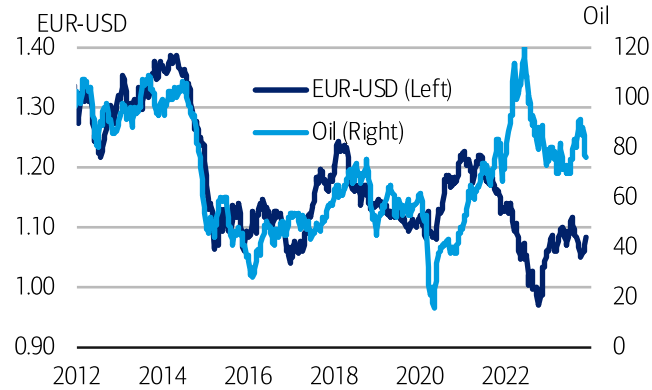
Exhibit 6: Oil and EUR
USD has been a beneficiary from recent oil spikes



Source: Bloomberg and BofA Global Research

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In particular, geopolitical worries persist (see Global Economic Viewpoint, "Geopolitics are here to stay", 21 Nov 2023), but concerns around oil have been pronounced and particularly surprising to markets in both directions. USD has generally moved higher amidst upside spikes in oil prices, and was distinctively seen during concerns around the energy market as a result of the Russian invasion of Ukraine (Exhibit 6; see Liquid Insight, "Oil supply shock and FX", 03 Oct 2023). The converse has also been true as well, especially, as lower oil prices have mechanically helped to cool headline inflationary pressures, reduce expectations for central bank policy restrictiveness, and reversing previous USD strength.

Exhibit 7: G10 FX Forecasts
We look for USD downside in 2024 and 2025

	Spot	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
G3										
EUR-USD	1.09	1.05	1.07	1.10	1.15	1.15	1.16	1.17	1.18	1.20
USD-JPY	148	153	155	150	146	142	140	138	136	136
EUR-JPY	162	161	166	165	168	163	162	161	160	163
Dollar Bloc										
USD-CAD	1.37	1.36	1.35	1.34	1.32	1.30	1.30	1.30	1.30	1.30
AUD-USD	0.65	0.64	0.66	0.68	0.71	0.71	0.71	0.71	0.71	0.71
NZD-USD	0.60	0.59	0.60	0.62	0.63	0.63	0.63	0.63	0.63	0.63
Europe										
EUR-GBP	0.88	0.87	0.87	0.87	0.88	0.88	0.87	0.87	0.86	0.86
GBP-USD	1.25	1.21	1.23	1.26	1.31	1.31	1.33	1.34	1.37	1.40
EUR-CHF	0.97	0.96	0.96	0.96	0.97	0.97	0.98	0.98	0.99	1.00
USD-CHF	0.88	0.91	0.90	0.87	0.84	0.84	0.84	0.84	0.84	0.83
EUR-SEK	11.45	11.50	11.70	11.40	11.20	11.10	11.10	11.00	10.90	10.80
USD-SEK	10.47	10.95	10.93	10.36	9.74	9.65	9.57	9.40	9.24	9.00
EUR-NOK	11.74	11.70	11.60	11.30	11.00	10.90	10.90	10.80	10.70	10.60
USD-NOK	10.73	11.14	10.84	10.27	9.57	9.48	9.40	9.23	9.07	8.83

Forecast as of Nov-20-2023. Spot exchange rate as of Nov-20-2023. The left of the currency pair is the denominator of the exchange rate. **Source:** BofA Global Research

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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Investors chasing the USD lower, **Liquid Cross Border Flows**, 20 Nov 2023

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