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Liquid Insight

USD: Anatomy of a selloff – positioning vs. rate differentials

14 November 2023

Rates and Currencies Research
Global

Key takeaways

- USD selloff has been broad-based, yet shifts in rate differentials have been more mixed, with some G10 moves favoring the USD
- FX positioning and sentiment has likely played a role, as investors still see "long USD" as among the most crowded trades
- US econ outperformance continues, as pricing of Fed cuts is most among G10. Recoupling needed for continued USD depreciation

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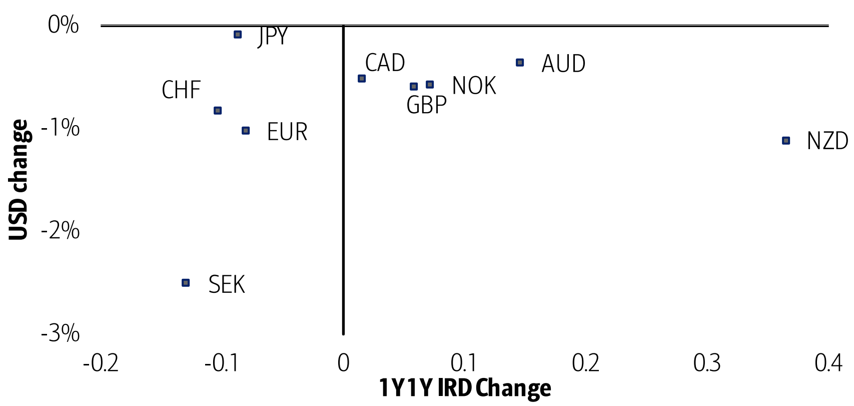
By Alex Cohen

Chart of the Day: USD performance vs. G10 FX vs. change in 1y1y OIS interest rate differentials (IRD) since 10/31/23

USD depreciation since pre-FOMC has not uniformly tracked with changes in IRDs (+IRD favors US)



source: Bloomberg; BofA Global Research

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USD's selloff in spite of mixed rate performance

The USD's net-depreciation this month has occurred amid a more mixed shift in interest rate differentials (Chart of the Day). In many G10 pairs, these differentials have concurrently moved in favor of the USD, suggesting other forces, such as positioning are at play. Indeed, recent surveys point to perceptions that long-dollar positioning is still amongst the most crowded trades, and sentiment has shifted sharply from positive to more neutral over recent weeks. Meanwhile, net long USD positioning by hedge funds remains around the highest levels of the past few years, potentially highlighting further vulnerabilities. Sill, relative upside US economic growth continues to stand out amongst G10 peers, while the Fed is priced for the most cumulative rate cuts into 2025. For the USD downtrend to continue in earnest, a greater growth recoupling will likely be a key prerequisite to intensify Fed cut expectations and further position adjustments.

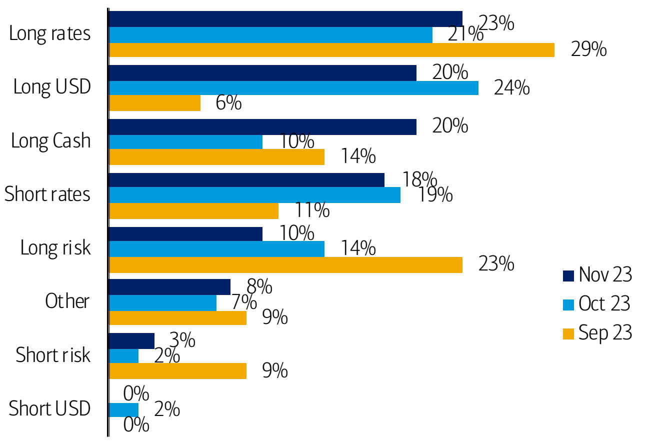
FX sentiment & positioning set the stage for the USD's sell-off

Views on the USD evolved notably over the summer/fall, with some select sentiment and positioning measures having recently reached the highest/longest levels of the year in late October, before paring back. This followed a much more USD-bearish consensus during the first half of the year, when the market was fixated on US disinflation, credit contraction, and Fed cuts in H2 2023.

Regarding current readings of sentiment, our previous two monthly FX and Rates Sentiment Surveys have uncovered interesting insights on the USD's perceived positioning and outlook (FX and Rates Sentiment Survey: I have a dollar 13 October 2023; FX and Rates Sentiment Survey: USD positioning unwind has begun 10 November 2023). Most notably, at the time of the October survey, when the USD was sitting at YTD highs, the "long USD" position was viewed as the most crowded trade (Exhibit 1) while both "exposure" and "view" on the USD reached the highest levels in a year (Exhibit 2).

This backdrop suggested the USD could be vulnerable to a quick positioning reversal. Indeed, the beginning of November saw the sharpest weekly USD decline in several months amidst a confluence of drivers, underscoring these positioning related vulnerabilities (FX Watch: USD: Three questions after last week's selloff 07 November 2023). As a result, perceptions of long-USD as the most crowded trade receded in the November survey, while the "view" on the USD has dropped sharply to more neutral levels.

Exhibit 1: FX & Rates Survey: Most crowded trade?
"Long USD" has gone from most (Oct) to second most (Nov) crowded trade



Source: BofA Global Research FX and Rates Sentiment Survey

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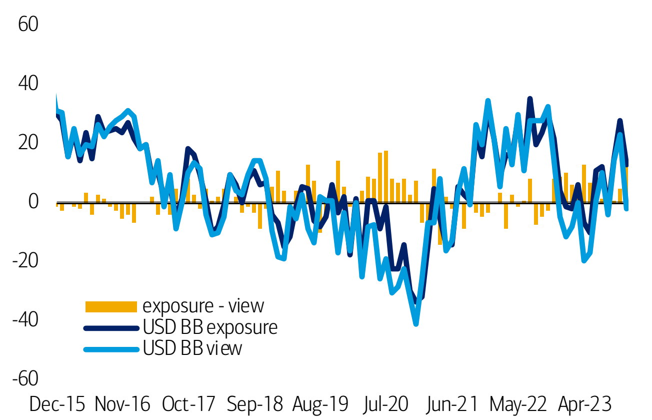
Exhibit 2: FX & Rates Survey: USD Sentiment and View
USD sentiment dropped from highest level in a year



Source: BofA Global Research FX and Rates Sentiment Survey
BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.

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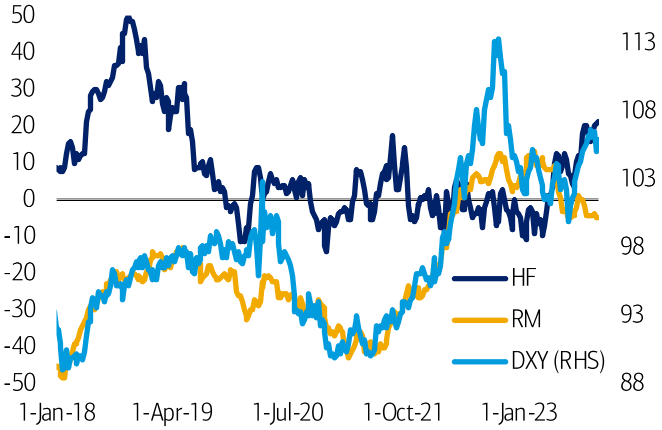
These observations are consistent with our weekly positioning data (Liquid Cross Border Flows: As the year ends 13 November 2023). While real money has not appeared to have participated in the USD's summer uptrend, the move has been accompanied by hedge fund positioning rising to the highest levels since prior to COVID (Exhibit 3). This could be the next vulnerability for the USD, should bearish-USD signals persist, or if consolidating year-end dynamics take hold over the next few weeks.

Exhibit 3: DXY & USD positioning: hedge funds and real money
HF USD positioning has risen to highest levels since pre-COVID



source: BofA Global Research; Bloomberg

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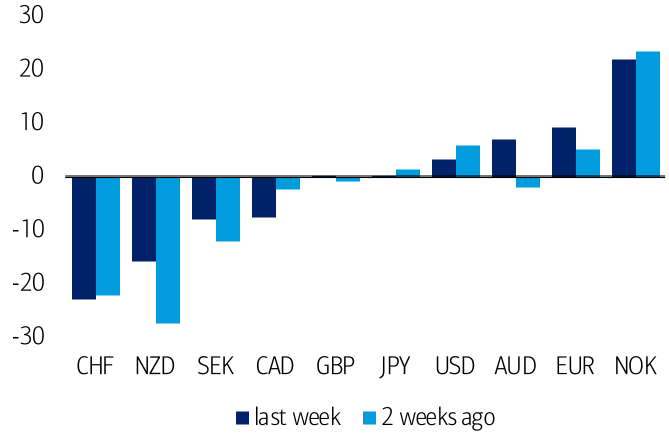
Exhibit 4: BofA Positioning Scorecard aggregate: previous 2 weeks
modest USD positions pared back; notable short covering in NZD and SEK



Source: BofA Securities, Bloomberg. Aggregate positioning is the equally-weighted average of five inputs (BofA Hedge Funds, BofA Real Money, a signal from our monthly FX & Rates sentiment survey, TFF Leveraged Funds, TFF Asset Managers). Each signal is scaled to +50 and -50. Where fewer than five inputs are available (Scandies, CHF), aggregate positioning assigns equal weights to all available inputs.

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G10 FX moves inconsistent with recent shift in rate differentials

Further supporting the influence that positioning has had on the USD recently is the fact that the USD's most recent net sell-off has not been accompanied by clear and consistent shift in relative policy outlooks between the Fed and other G10 central banks. Indeed, as seen "Chart of the Day", the change in G10 1y1y OIS rate differentials (proxy for forward looking policy expectations) since just prior to the November FOMC and October employment report, did not shift universally against the USD vs other G10 currencies.

These rate differentials are little-changed- to- net-wider (favoring the US) vis-à-vis the GBP, NOK, AUD and NZD, despite the USD having depreciated on net vs. all these currencies to varying degrees. The NZD's performance stands out as the biggest outlier among them (1.1% NZD/USD appreciation against a 23 bp narrowing in rate differentials vs. the US), as short-NZD was the largest G10 currency on our positioning scorecard two weeks ago, before paring back sharply (Exhibit 4).

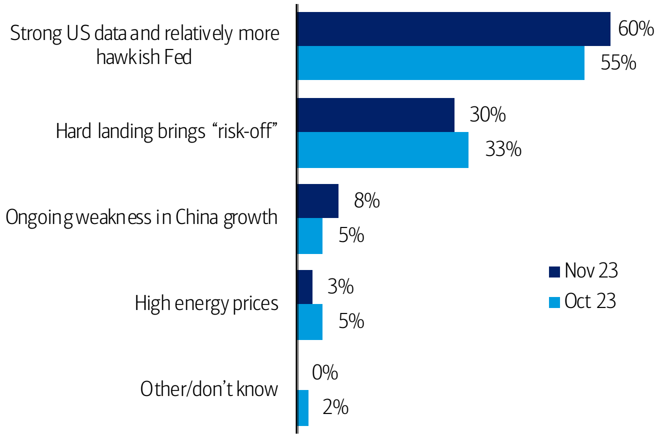
On the other side, rate differentials have narrowed (against the US) between 8 and 10 bps vs. the JPY, EUR, CHF and SEK. The SEK, notably, has been the top performing G10 currency during this time, supported in part by upside Swedish data, though net-short positioning was third amongst the G10, similarly contributing to the outsized currency move.

USD Outlook: All about the data

Reverting again to our recent FX & Rates Sentiment survey, the predominant anticipated driver of the USD into the beginning of next year is unsurprisingly the evolution of US data and the corresponding Fed stance. This is apparent both for upside and downside drivers of the USD, and these views have become more entrenched over the past month, compared to alternative drivers (Exhibit 5, Exhibit 6).

Exhibit 5: FX & Rates Sentiment Survey: Biggest upside risk to the USD over the next 6 months?

Upside US data/hawkish Fed to drive the USD higher...



Source: BofA Global Research FX and Rates Sentiment Survey

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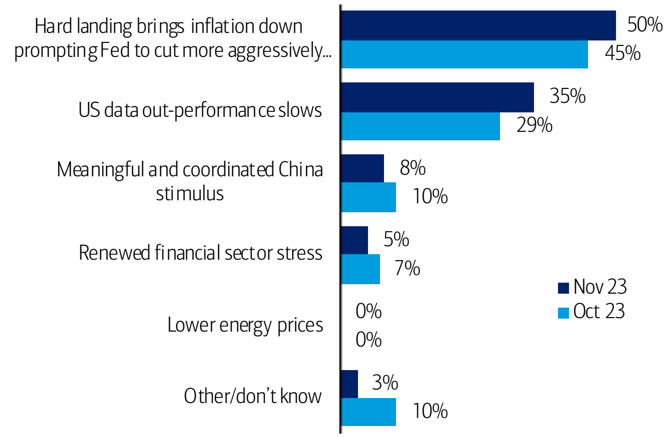
Exhibit 6: FX & Rates Sentiment Survey: Biggest downside risk to the USD over the next 6 months?

Downside US data/dovish Fed to drive the USD lower...



Source: BofA Global Research FX and Rates Sentiment Survey

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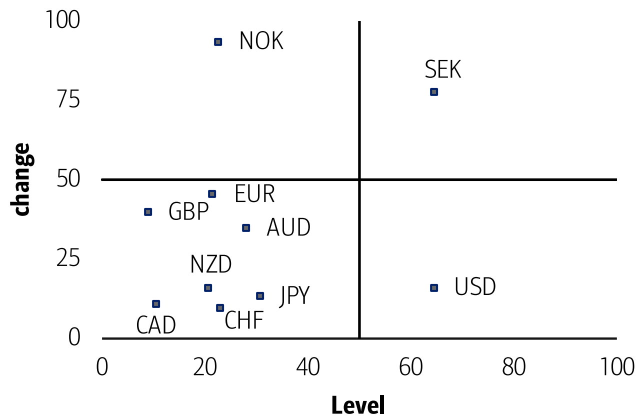
As recent rates move and positing dynamics show, the USD's positioning driven selloff appears slightly overdone based on relative changes in policy outlooks. This likely speaks to the market's seeming desire to capture the USD's next big move, which many (us included) believe to be eventually lower. However, for this to be comfortably more entrenched, clear signs of economic re-coupling between the US and the rest of the G10 will need to be more evident. The more recently benign changes in relative policy pricing is likely due to still persistent overall US growth outperformance, despite recent readings.

Exhibit 7 shows the percentiles of G10 economic surprise indices, both in level ranks, and changes in those ranks over the past 10 days. Only the US and Sweden have economic surprise index levels in the top half of readings, and only Sweden has also had 10-day improvements in those indices registering in the top half of such changes. While this snapshot measure is highly fluid, it is one way of capturing both outright and trends in data surprises. Meanwhile, Exhibit 8 shows the cumulative pricing of rate changes implied by interest rate futures for G10 economies (ex-Japan) through mid-year 2025. Here, pricing of Fed cuts is among the most aggressive of the G10, reflecting some combination of a US-led growth slowdown and/or relative improvement in inflation. For the USD downtrend to become more entrenched, data convergence and rate-path divergence will need to become more pronounced.

Exhibit 7: G10 Economic surprise percentiles (3y rank): levels and past 10 day change

Recent data surprises to the downside in most of G10; US and Scandies the exceptions



Source: Bloomberg; BofA Global Research

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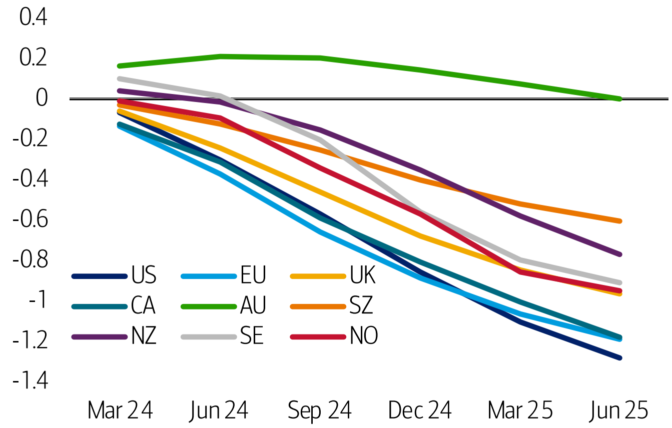
Exhibit 8: Cumulative change in implied interest rate futures curves from December 2023

Most G10 CB's priced to cut steadily into 2025; most cuts implied for the Fec



Source: Bloomberg; BofA Global Research. Note: Data derived from select interest rate futures curves; SE & NO use estimates based on OIS curves

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Turning point**, Global FX Weekly**, 10 Nov 2023
- Bond fairy tails, **Global Rates Weekly**, 10 Nov 2023
- USD sell-off can extend, **Liquid Cross Border Flows**, 6 Nov 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: Turning point 10 November 2023

Global Rates Weekly: Bond fairy tails 10 November 2023

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