FX Viewpoint

USD: Bulls versus Bears

29 February 2024

G10 FX Strategy
Global

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Key takeaways

- FX conviction is low, as the market seeks a fresh catalyst for the USD. Here we compare the bullish and bearish USD outlooks:
- USD bears are consensus, seeing further disinflation as soon prompting a dovish Fed pivot, pushing the USD toward equilibrium
- USD bulls emphasize US growth outperformance & see sticky service inflation keeping Fed on hold longer than market is pricing

USD bulls and bears square off

FX conviction is low at present. The USD began the year on the back foot, as expectations for Fed easing in Q1 mounted. Strong data and a more balanced Fed message have upended that, leaving the market thirsty for a fresh catalyst. The USD has recently lost momentum as market pricing of the fed funds path is much closer to the Fed's guidance. Here we present both the bullish and bearish cases for the USD, as it is prudent for investors to consider the risks to their own priors.

CRE: commercial real estate

FOMC: Federal Open Market Committee

PCE: personal consumption expenditure

A bearish case for the USD

Market consensus sees the USD trading lower this year, as a number of the factors supporting it over recent years are primed to fade. Despite recent upside surprises, US inflation readings are softening, particularly when looking at recent readings of the more policy-relevant core PCE and factoring in possible January distortions. Fed policy is relatively too restrictive for the impending inflationary environment, and a real-rate convergence is on the horizon, bringing the USD lower with it.

A bullish case for the USD

Dollar bulls have clung to the so-called "US exceptionalism" narrative and see broad measures of relative growth outperformance as a cornerstone to capital seeking the US. Despite disinflation trends, stickiness in the more core services component should keep the Fed from pivoting early, as it has widely communicated. Several risk factors (US election, geopolitics, hard landing risks) skew USD positive, while CRE/reginal bank flare-ups (likely USD negative) have not been shown to be widespread at present.

Bottom line

Inflation (versus growth) should be a marginally bigger determinant of Fed policy amid a resilient US economy, but interpretation is in the eye of the beholder. We maintain our bearish USD forecasts for the year, consistent with BofA Global Research economists' expected soft landing, but patience is required. That said, upside risks are becoming more glaring, and a further repricing of Fed expectations (which are now at long last in sync with each other) could be the next catalyst to turn this year's consolidation into a bigger trend.

Refer to important disclosures on page 12 to 13.
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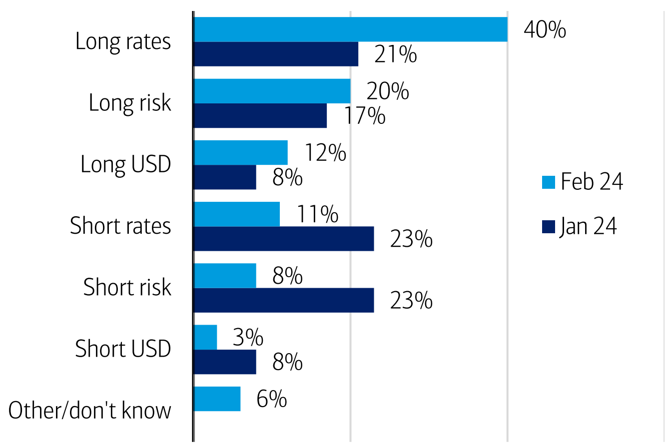
FX conviction remains low

Conviction in the FX market is low. Coming into the year, USD sentiment was clearly on the back foot, as softening inflation readings and a surprisingly dovish December FOMC got the market excited for catching the next big trend lower after years of overvaluation and outperformance. This has all been upended to start the year, as US growth and inflation data has tended to surprise to the upside, while the Fed has struck a much more balanced tone. Market expectations for the Fed's path have reacted accordingly, and as a result, the USD has broadly outperformed. More recently, however, the USD rally has lost some steam, as investors debate the likelihood of further upside catalysts against what some see as noisy and overstated January US data.

This seeming lack of conviction is reflected in our positioning and sentiment data. As seen in our February FX & Rates Sentiment Survey (Exhibit 1), long and short USD views registered among those with the lowest conviction when compared to equity and rates outlooks (see the report , FX and Rates Sentiment Survey: Self confident 09 February 2024).

Likewise, our FX positioning data (Exhibit 2) indicates neutral USD positioning amongst the broader market, as hedge funds have moved from short to long since last year, while real money has been largely on the sidelines – remaining (but not materially adding to) net-short USD (see the report, Liquid Cross Border Flows: When in doubt... 26 February 2024).

Exhibit 1: Highest conviction view to start 2024, according to survey
Long rates conviction has strengthened despite positioning concerns



Source: BofA Global Research FX and Rates Sentiment Survey

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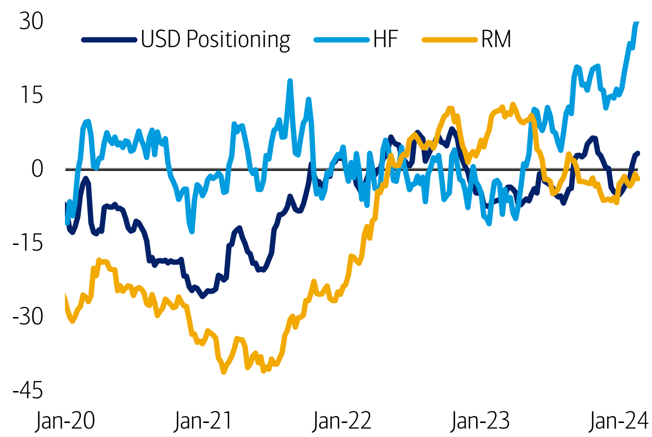
Exhibit 2: BofA USD Positioning: Aggregate, Hedge Funds, & Real Money
Aggregate positioning data continues to reflect lack of USD conviction



Source: BofA Securities

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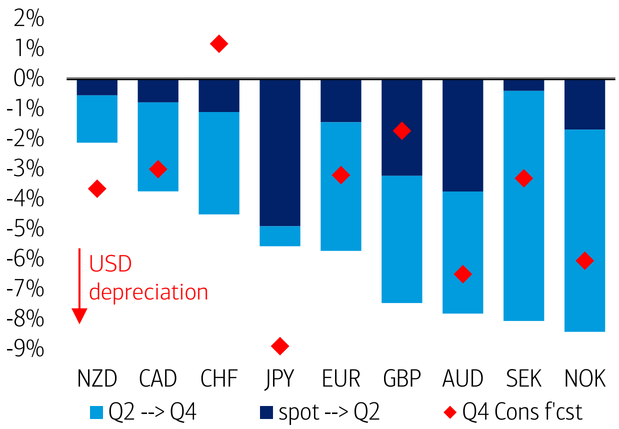
Nevertheless, market consensus still calls for broader USD downside this year. As seen in Exhibit 3, the median forecasts (as proxied by submission to Bloomberg) imply a lower USD vis-à-vis all G10 currencies except CHF. Our forecasts similarly call for the USD to depreciate against the board. Here, a few nuances are key to point out.

1. We mostly see USD depreciation as more of an H2 story, rather than H1 (see light blue bars versus dark blue bars),

2. For the year, we are more bearish USD than consensus for all pairs except NZD and JPY.

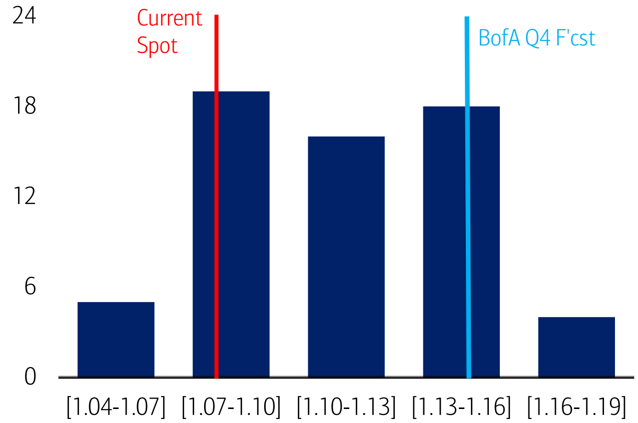
Using EUR/USD as an example, Exhibit 4 reflects how evenly distributed consensus forecasts are, with the center of the distribution closer to our Q2/Q3 call.

Exhibit 3: Implied USD move: BofA and Consensus Forecasts for 2024
We expect greater USD depreciation this year than consensus for most pairs; mainly a story for H2



Source: Bloomberg; BofA Global Research

Exhibit 4: Distribution of 2024 Q4 EURUSD Forecasts
BofA on the right side of EURUSD distribution for Q4 forecasts



Source: Bloomberg; BofA Global Research

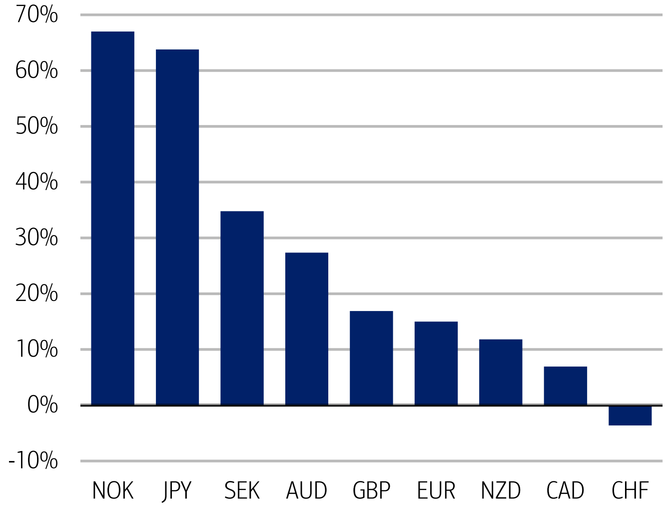
Against this backdrop, we dig deeper into both the bull and bear cases for the USD this year. This can be informative, regardless of which (if either) side of the fence one finds themselves – either by reinforcing views or presenting risks to consider.

Bearish case for the USD

We start with the bearish USD view, given that this view is embedded in our (and consensus) FX forecasts. The bearish narrative goes something like this:

- After two years of justifiable USD outperformance (US growth outperformance, the Fed's credible fight against inflation, high nominal and real rates leading to positive carry versus most of the G10, US energy independence shielding the economy from global shocks, delayed China re-opening from COVID, flight to quality insurance), the global economic normalization process should finally start to get under way.
- Whereas the US had "decoupled" higher from the rest of the world, this year should be more about the US "recoupling" lower. As inflation falls globally, the Fed and most other G10 central banks will likely embark on the process of lowering rates to prevent excessively tight monetary conditions. Pessimism outside the US is well priced in.
- Even if other central banks are reducing rates alongside the Fed, the lower US rates should benefit foreign entities with USD liabilities and should matter more for global risk sentiment, supporting equities and higher-beta currencies versus the USD.
- Furthermore, given the US's rate advantage, there is theoretically more room for the Fed to cut, all else equal. With the USD being the most overvalued G10 currency by most metrics, the global cutting cycle finally getting under way should allow the USD to finally adjust lower towards equilibrium (Exhibit 6, Exhibit 6).

Exhibit 5: Misalignment from equilibrium, USD G10 crosses, based on BEER model (positive for overvalued USD)
NOK, JPY most undervalued, CHF, USD most overvalued in G10



Source: BofA Global Research

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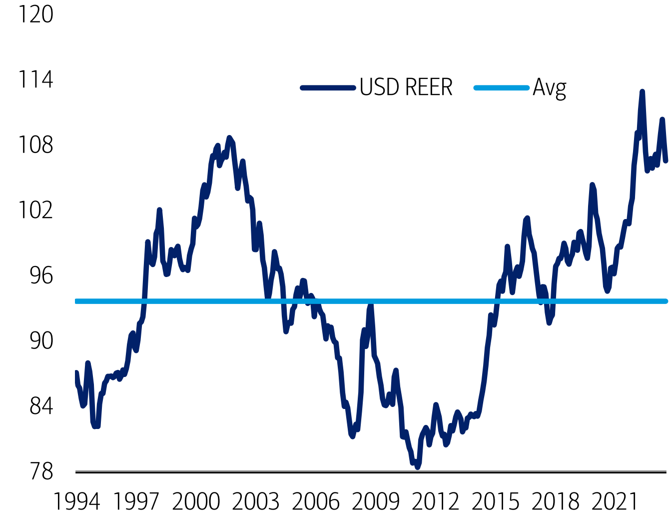
Exhibit 6: USD Real Effective Exchange Rate
USD REER elevated below the multi-decade highs



Source: Bloomberg; BIS; BofA Global Research

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USD weakness: It's all about (dis)inflation

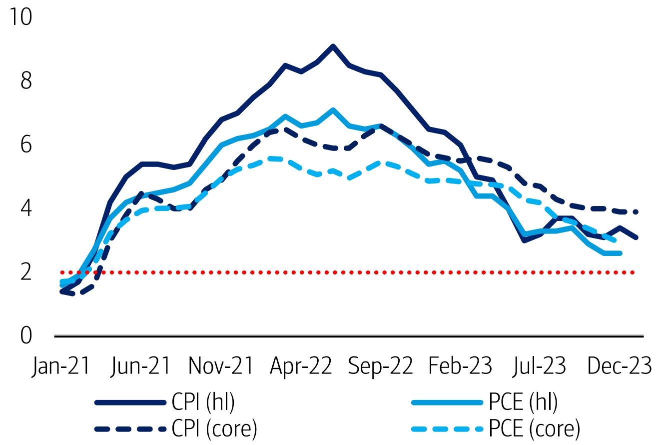
Various inflation prints in the US this year have often read like a "choose your own adventure" book. While the narrative recently has been the recent upside CPI reports, dollar bears have emphasized a variety of "under-the-hood" aspects to downplay otherwise hot readings, arguing that a shift towards rate cuts should be more imminent.

First, recent readings point to an apparent wedge forming between CPI and PCE (Exhibit 7). This is due in large part to housing inflation [rent and owners-equivalent rent (OER)], which gets notably more weight in CPI than PCE. Given the current structure of the US housing market, the transmission of tighter monetary policy to housing prices has lagged, as higher rates exacerbate housing supply constraints, pushing up demand for rents.

With core PCE being the Fed's preferred inflation gauge, USD bears have been quick to overlook the more upside CPI readings in favor of the closer to 2% PCE readings. This narrative reached its apex last month, as the upside December CPI was overshadowed by softer PPI and PCE readings (see the report, US Watch: December PCE inflation tracking: Another step closer for the Fed 12 January 2024, US Watch: Soft inflation, strong spending keep a March cut in balance 29 January 2024).

Exhibit 7: US CPI and PCE inflation readings (YoY)

Fed's preferred measure (PCE) structurally below CPI



Source: Bloomberg; BofA Global Research

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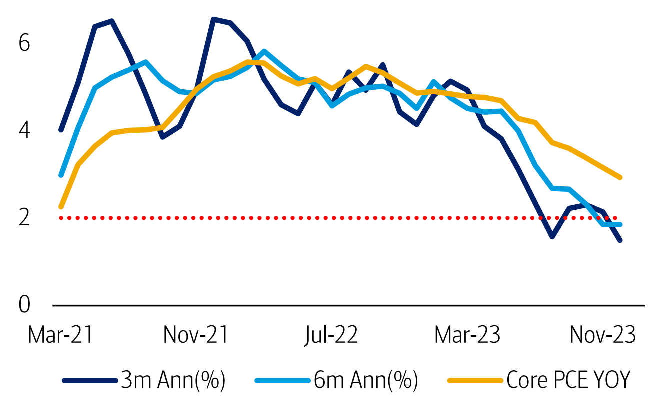
Exhibit 8: US Core PCE: YOY, 3m annualized, 6m annualized

Recent monthly core PCE readings suggest pronounced disinflation



Source: Bloomberg; BofA Global Research. m = month.

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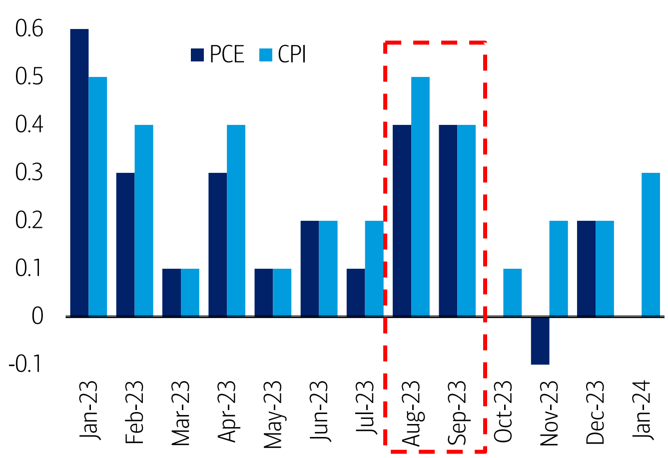
The bearish dollar case is also argued from the perspective of recent dis-inflation trends. Rather than focusing on YoY readings, improvements in inflation can be better seen, so this argument goes, in the 3- and 6-month annualized figures. As seen in Exhibit 8, when looking at the 6-month annualized core PCE reading, dollar bears could argue that inflation is already essentially at target. This point is further emphasized in Exhibit 9, demonstrating that the most recent outsized MoM readings occurred last August and September, which will soon fall out of the 6-month annualized calculations.

Finally, the most recent soft-inflation/USD-bearish interpretation came after the upside January CPI report (see the report, [US Watch: January CPI Inflation: detour from disinflation 13 February 2024]). Indeed, while the prints exceeded expectations across the board, USD bears were quick to point to the abnormal divergence of OER (above rental inflation), impacts of weather distortions, and January seasonality as reasons to be skeptical of the print. Similar arguments were made about the recent pickup in hourly earnings in the January employment report, as a concurrent drop in hours worked suggested the potential for more signal than noise in the reading (Exhibit 10).

Exhibit 9: US CPI and PCE: MoM

Elevated monthly readings from August and September soon to fall from 6-m calculations



Source: Bloomberg; BofA Global Research

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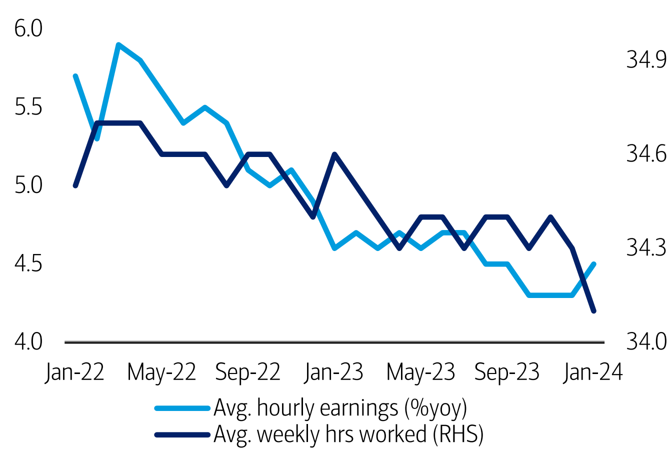
Exhibit 10: US wages and hours worked in January

January wage pickup coincides with drop in hours worked, suggesting weather distortions



Source: Bloomberg; BofA Global Research

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“The Fed is fickle; it won’t take much to pivot again”

It was not long ago when the Fed seemed much more comfortable with impending easing, than it has communicated recently. Dollar bears see the Fed as still susceptible to another abrupt dovish pivot, consistent with the inflation outlook discussed above.

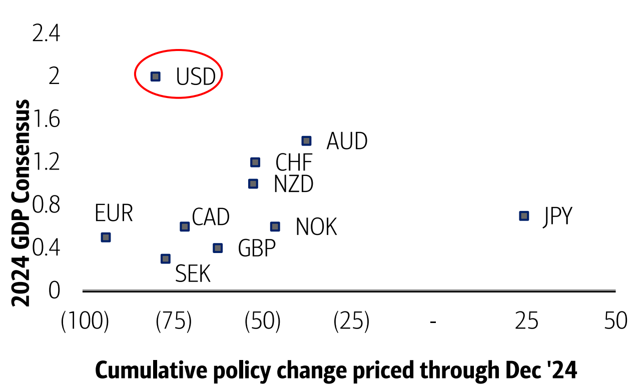
The about-face between the December and January FOMC meetings has been well covered at this point, as Powell’s surprise commentary late in the January press conference that a March cut was unlikely served to support the USD amid a notable re-pricing of expectations.

However, prior to that specific pushback on a potential March cut, the meeting had some dovish overtones. Most notably, when discussing conditions to cut at the press conference, Powell downplayed robust growth and employment being a hindrance: *“...We have had a very strong labor market, and we have had inflation coming down. So, I think, whereas a year ago we were thinking we needed to see some softening in economic activity, that hasn't been the case. So, I think we look at stronger growth -- we don't look at it as a problem.”* USD bears see this reason to discount the upside growth and employment data as a roadblock to easing, thus placing greater weight on disinflation signals. As shown in Exhibit 11, despite stand-out relative growth expectations for the US this year, rate markets still price the Fed to cut around as much or more than most of the G10 (except the ECB).

Nevertheless, upside growth and inflation data, along with Fed guidance, has brought the expected policy path much closer to the Fed’s dot-plot from December (Exhibit 12). However, more recently, the USD uptrend has lost momentum, likely suggesting that another fresh catalyst is necessary for dollar upside to continue.

Exhibit 11: 2024: Real GDP Forecasts vs. implied CB rate change

Despite stand-out US growth expectations, Fed expected to cut as much/more than other G10 central banks



Source: Bloomberg; BofA Global Research

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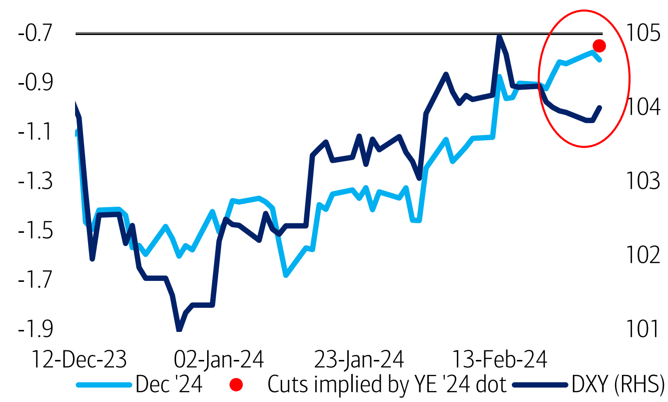
Exhibit 12: DXY & cumulative Fed cuts implied by Dec FOMC (OIS)

USD upside momentum has waned as market approached Fed dot plot



Source: Bloomberg; BofA Global Research

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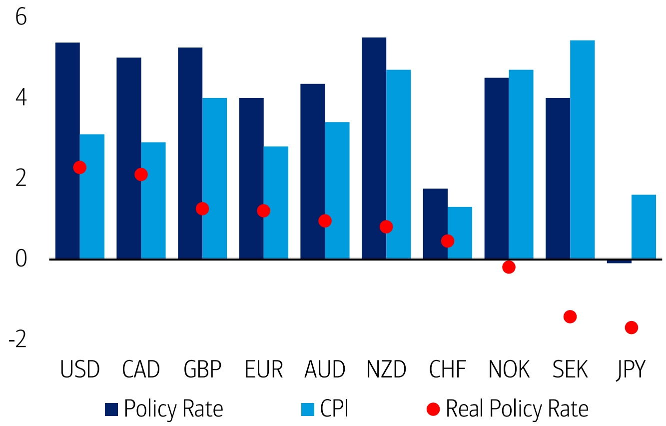
Dollar bears see that catalyst as elusive, and if disinflation trends continue, the Fed should have increasing scope to cut. Here, real rates, as a measure of relative accommodativeness/restrictiveness, can be a useful guide. Indeed, as seen in Exhibit 13, US policy rates less headline CPI is highest among the G10, a key factor supporting the USD over recent years. All else equal, this suggests that in a more benign inflationary environment, the US has relatively more scope to reduce rates to reach neutral. Conversely, these same dynamics imply that other countries possibly having scope for relatively more restrictive policy, though growth considerations act as a hinderance.

Exhibit 14 shows the DXY against a measure of DXY weighted 5-year sovereign inflation adjusted yields. Since last year, the USD has undershot this real-rate differential compared to the run-up through 2022, possibly indicating that the market has been pricing an anticipated real yield compression into the USD.

Exhibit 13: G10: Policy Rates, CPI, & Real Rates
US has the highest real policy rate in the G10



Source: Bloomberg; BofA Global Research

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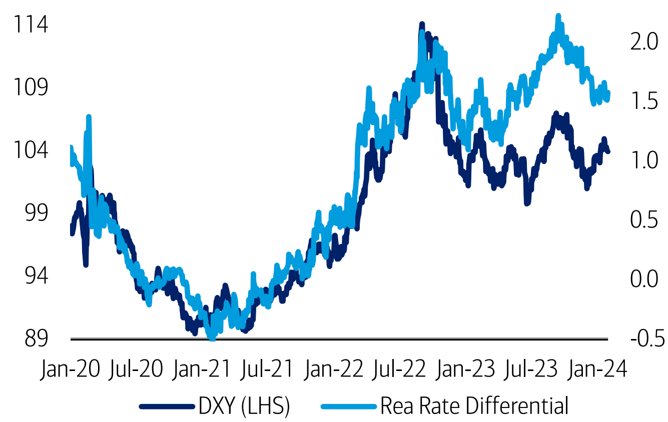
Exhibit 14: DXY & Real rate differential (DXY weighted)
USD has lagged recent widening in real rate differentials



Source: Bloomberg; Bofa Global Research

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Bullish case for the USD

Dollar bulls generally acknowledge aspects of the bear case, particularly as relates to valuation, the broader disinflationary trend, and eventual policy normalization. However, the differences largely relate to 1) assessment of the incoming data, 2) the Fed's perceived reaction function and timing, and 3) USD directionality of a number of risk factors.

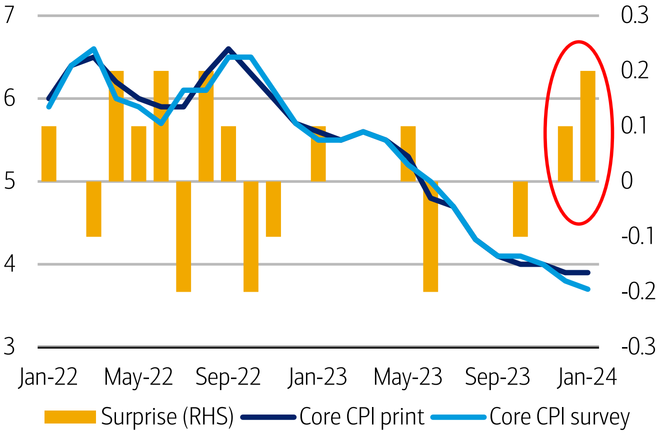
USD strength – It's all about inflation

While inflation is coming down, it is difficult to rule out the scenario whereby inflation at best remains sticky on the way to 2% or even resurges (see the report, The Global Thinker: Let's talk about inflation risks 30 January 2024). Despite various reasons (discussed above) that USD bears might be skeptical with recent inflation readings, CPI has nonetheless surpassed expectations for the past two months, as did the January PPI (see the report, US Watch: January PCE inflation tracking: Two steps back 16 February 2024 and Exhibit 15).

The bullish dollar camp tends to also look beyond the headline readings to emphasize signs of stickiness in the sub-components. Most notable here is the ongoing divergence between core goods and core services, with the latter being the main source of overall inflation (Exhibit 16). Moreover, the Fed has consistently placed particular significance on the core services ex-housing component, which for CPI recently printed at its highest monthly level since April 2022. This fits in with the adage that the so-called "last mile" of inflation fighting is the hardest and will require policy to remain tight for longer than many would like to see (see the report, Liquid Insight: The difficult last inflation mile 26 February 2024).

Exhibit 15: US Core CPI: Actual and Expected

Recent core CPI readings have printed notably to the upside, supporting US rates and the USD



Source: Bloomberg; BofA Global Research

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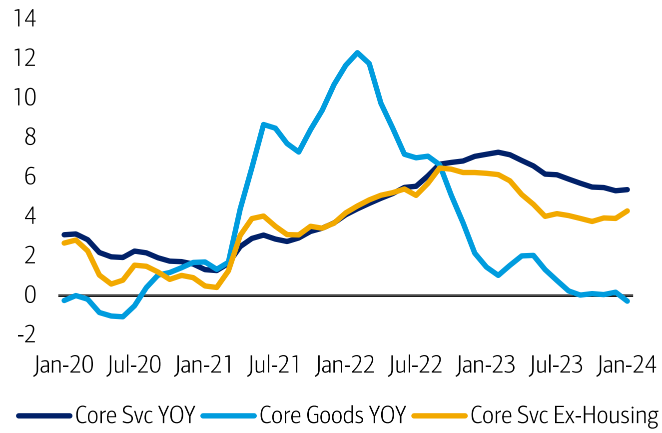
Exhibit 16: US core CPI components: goods, services, services ex-housing

US services inflation remains sticky



Source: Bloomberg; BofA Global Research

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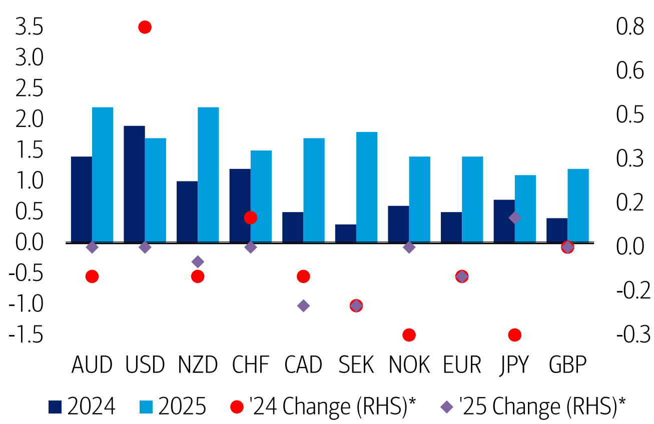
"US exceptionalism"? Don't write it off just yet

Beyond these select inflation trends, dollar bulls also look towards a broader set of growth measures to assess the overall US economic picture, often citing so-called "US exceptionalism" related to other major global economies. As noted above, US real GDP expectations stand out among the G10, both for 2024 and 2025, and expectations have been notably upgraded in recent months (Exhibit 17). Further, the highly watched Atlanta Fed GDP Nowcast has trended upward this year and currently is above 3%. Consistently, while other economies are showing greater expansion of the services sector than the US, it and Norway are the only two G10 with above-50 manufacturing and services PMIs (Exhibit 18).

Exhibit 17: 2024/25 Consensus real GDP and 3m changes

US growth expectations stand out among G10 and were recently revised higher



Source: Bloomberg; BofA Global Research; *change since Nov 23

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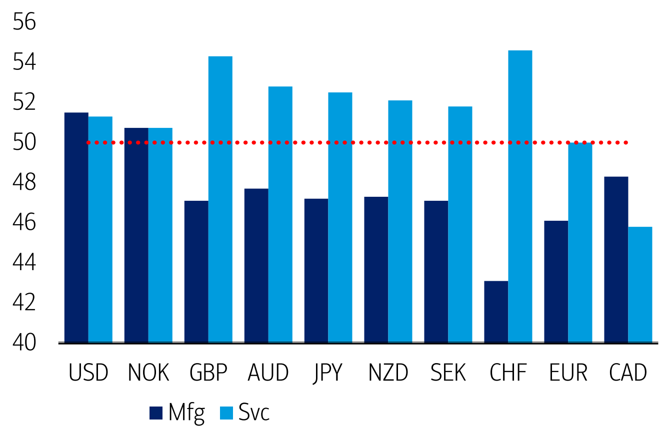
Exhibit 18: Global PMIs: Services and Manufacturing

US PMIs both in expansionary territory



Source: Bloomberg; BofA Global Research

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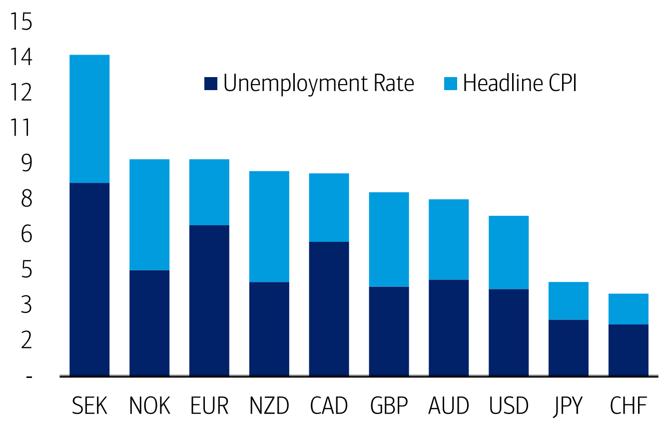
Elsewhere, signals from the labor market and consumer also stack up well for the US on balance. While unemployment remains relatively low all across the G10, the resilient labor market in the US has been a focal point of this cycle. Viewing the inflation data in this context, we note that the so-called "misery index" (inflation + unemployment) in the US is the lowest in the G10, with the exception of Switzerland and Japan – two economies with structurally low inflation and unemployment (Exhibit 19). On this basis, the US economy is relatively better equipped to withstand tighter monetary conditions. On the consumer side, confidence readings across the G10 indicate above-average conditions only in the US, using a 10-year Z-Score across measures (Exhibit 20).

Exhibit 19: G10 "Misery Index" (Unemployment and CPI)
US Unemployment and inflation third lowest in the G10



Source: Bloomberg; BofA Global Research

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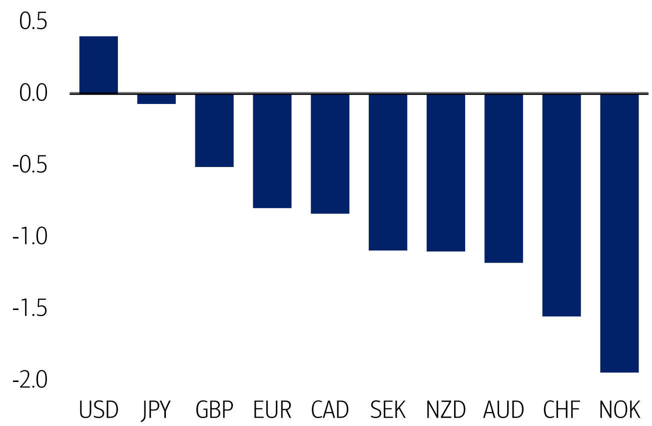
Exhibit 20: G10 Consumer Confidence Z-Scores (10-year lookback)
US only G10 economy with above-average consumer confidence readings



Source: Bloomberg; BofA Global Research

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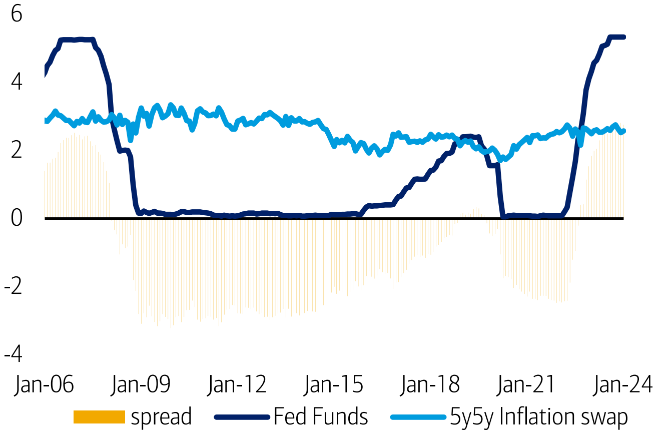
"Fed credibility is alive and well – don't fight the Fed"

Over the course of the last year, much of the USD bearish case centered on expectations that the Fed would blink at the first sign of financial stress/economic softness, thus causing yields to drop substantially and the USD to sell off. Such an outcome could have forced inflation expectations higher and made Fed policy look inappropriately less restrictive. Clearly, this did not happen, as evidenced by the spread of fed funds to inflation expectations (5y5y swap) reaching its widest level since just ahead of the financial crisis in 2008 (Exhibit 21). This creditability should continue to keep inflation expectations at bay, serving as a foundation for USD support amid a clear commitment to appropriately restrictive policy.

Interestingly, this relative policy tightness has not translated into overly tight financial conditions, as many had feared (Exhibit 22). Toward the end of last year, the Fed was vocal about the implications that tightening financial conditions would have on the economy, possibly necessitating less actual monetary restrictiveness. Clearly, this has not played out, likely due in part to buoyant equity markets fueled by exuberance in Tech/artificial intelligence (AI)-related stocks and the effects of loose fiscal policy. But regardless, easy financial conditions should imply less urgency from the Fed to pivot to rate cuts, all else equal, as doing so would push financial conditions even easier, risking a resurgence of inflation. Across the board, this lack of urgency for cuts has been a common thread in recent Fed official communications.

Exhibit 21: Fed Funds & 5y5y Inflation Expectations
Fed Funds in excess of inflation expectations around highest level since pre-2008 crisis



Source: Bloomberg; Bofa Global Research

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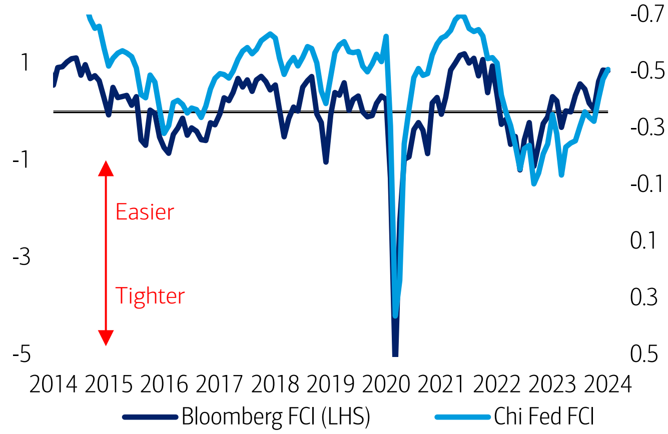
Exhibit 22: Financial Conditions Indices (Bloomberg and Chicago Fed)
Various FCI measures at easiest levels since 2021



Source: Bloomberg; Bofa Global Research

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Finally of note, last month, we explored the thought exercise of how currencies would be impacted if no central bank cut rates in 2024 (see the report, Liquid Insight: Thinking the unthinkable: what if no central bank cuts rates this year? 16 January 2024). We would view the USD as among the outperformers in this scenario, and while clearly not the base case, it feels much less implausible today than it did just 6 weeks ago.

Risks for both bears and bulls

Other than the standard macroeconomic and policy effects on currencies, here we touch on other themes that are not prevalent drivers of FX at the moment but have the potential to be later in the year.

US election

We covered the election risks for the USD last month, focusing on the stylized example of the biggest potential policy impact – a shift from status quo toward a Republican sweep (see the report, FX Viewpoint: USD Year Ahead: A winding road to depreciation 25 January 2024). In short, dollar bears emphasize the prospect of tailwinds to risk appetite from tax cuts and de-regulation as well as an anticipated shift over time to more dovish nominations to key Fed positions. Conversely, USD bulls see the election through the lens of possibly inflationary trade, labor, foreign and fiscal policies, keeping US yields elevated on net and posing greater economic challenges abroad. The near-term balance of these skews in the USD's favor, but it is still premature for the spot market to start pricing them in, given uncertainties.

Hard landing

The main bearish and bullish cases discussed above implicitly fit into the "soft landing" and "no landing" scenarios, respectively. Still unexplored here is the "hard landing" scenario and what that could mean for the USD. While not in the consensus base case, we view this scenario as one that is not necessarily straightforward and depends a lot on the severity as well as the global nature of such an outcome (see the report, FX Viewpoint: Various landing scenarios & the USD 01 March 2023).

A hard landing shock that comes on quickly would likely be bullish USD, at least for a period of time, as the market adjusts to a risk-off trading stance amid deleveraging and flight to the USD as a "safe haven." However, over time, the presumed sharp drop in US yields, even if accompanied by rate cuts elsewhere would likely eventually prompt allocation out of USD assets, as yield spreads compress and global risk appetite bottoms. Moreover, a slower building hard landing more isolated to the US could see more initial USD depreciation.

CRE/regional banks

Concerns over regional banks reached fever pitch about a year ago and from an FX perspective was seen as dollar negative, at least initially, as US banks were expected to significantly tighten lending standards, which could result in quicker/deeper Fed cuts (see the report, FX Watch: Financial turmoil, Fed re-pricing & the USD 29 March 2023). Clearly, this did not play out as feared then, and even recent wobbles in this space (which did weigh on the USD for a select number of days in late January/early February) have not persisted. Fed officials have suggested that these risks are distributed enough to not be systemic, but it nevertheless remains a vulnerability for the USD or any other currency closer to the epicenter of emerging risks.

Geopolitics/China

As we outlined in our year-ahead report, other key risks this year related to ongoing economic malaise in China and/or a supply induced oil price spike could present upside risks to the USD (see the report, FX Viewpoint: G10 FX Year Ahead: The year of the landing 20 November 2023). Perhaps surprisingly, Middle East tensions and Red Sea supply disruptions have yet to meaningfully be reflected in broader currency markets, but possible signs of stagflationary impact in Europe bear watching.

Bottom Line

If this year is anything like last year, the narrative shifts will come fast and frequently, pushing sentiment along with it. Inflation (versus growth) should be a marginally bigger determinant of Fed policy amid a resilient US economy, but interpretation is in the eye of the beholder. We maintain our bearish USD views for the remainder of the year, consistent with the BofA Global Research economic team's expected soft landing, but patience is required. That said, upside risks are becoming more glaring, and a further pushing out of the market's Fed expectations (which are now at long last in sync with each other) could be the next catalyst to turn this year's consolidation into a bigger trend.

Disclosures

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