Liquid Insight

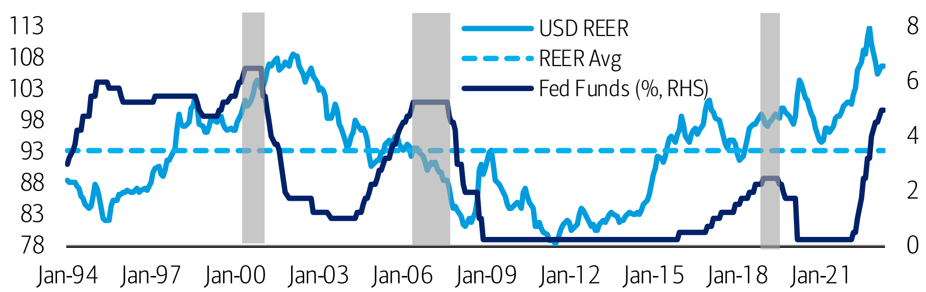
Pause and Effect: The USD at the end of hiking cycles

Key takeaways

- The past three periods where the Fed paused rate hikes (2000-01, 2006-07, 2018-19) produced differing results for the USD
- A common thread to each period: initial USD depreciation (between the last hike and first hold), but more variable afterwards
- The end of the cycle comes at a time of high USD valuation, but the pause by itself should not imply USD weakness.

By Alex Cohen

Chart of the Day: USD REER & Fed Funds
Fed will pause at a time of muti-decade USD strength



Source: BofA Global Research, Bloomberg, BIS

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Preparing for Pause

As the Fed just delivered what might be the last rate hike of this cycle, it is worthwhile to look at past cycles to assess the USD's performance. With fed funds now set to the range of 5.00-5.25 percent, market pricing and most analysts suggest that terminal rate for this cycle has been reached, barring a material resurgence in inflation.

Heading into this expected policy cycle top, the dollar has come off of the multi-decade highs reached in 2022, but remains strong by any valuation metric (see report: Forecasting G10 FX: An update). Further valuation adjustments from here are foundation of our medium-term forecasts for the dollar to depreciate gradually into 2H23/1H24 (see report: World at a Glance: The inflation fight in a slowdown). However, despite the impending Fed pause, we see the prospect of the dollar finding near-term support. Inflation has remained sticky and should keep the Fed committed to holding rates at terminal into 2024, well beyond market pricing. Indeed, current pricing suggests the Fed could possibly deliver the first cut as early as July, marking just a two-month pause period if realized. These expectations have contributed to a seemingly consensus bearish dollar view in the market.

08 May 2023

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Timestamp: 08 May 2023 12:30AM EDT

The past three Pause Periods

Aside from the current episode, there have been three tightening cycles this century:

- 2000-2001: Ended amid the bursting tech bubble
- 2006-2007: Ended ahead of 07/08 financial crisis
- 2018-2019: Ended ahead of (but unrelated to) COVID-19

Exhibit 1: Select Economic Data & Asset Price Changes during Pause Periods
Each period presented different backdrops and price action

	2000-2001	2006-2007	2018-2019	2023
Last Hike	16-May-00	29-Jun-06	19-Dec-18	5/3/2023?
First Cut	3-Jan-01	18-Sep-07	31-Jul-19	???
Duration (months)	8	15	7	--
Terminal FF	6.5	5.25	2.5	5.5?
Change in:				
DXY	-1.0%	-7.8%	1.5%	--
EUR/USD	3.1%	10.4%	-2.6%	--
USD/JPY	3.6%	0.8%	-3.3%	--
2Y UST (bp)	(194)	(121)	(77)	--
2Y Germany (bp)	(51)	49	(17)	--
GE-US 2Y IRD (bp)	144	170	60	--
SPX	-8.1%	19.4%	18.9%	--
NASDAQ	-29.6%	22.0%	23.2%	--
Brent	-13.03%	6.5%	13.9%	--
Level (Hike;Cut):				
US Unemployment	3.8;3.9	4.6;4.6	3.8;3.7	3.5
US CPI	3.1;3.4	4.2;2.0	2.2;1.8	5.6
EA CPI	1.9;2.5	2.3;1.9	2.1;1.4	7.0
US real GDP (Y/Y)	4.2;2.9	3.2;1.9	3.2;2.1	1.6
EA real GDP (Y/Y)	4.1;3.4	2.8;3.0	1.4;1.6	1.3

Source: BofA Global Research, Bloomberg

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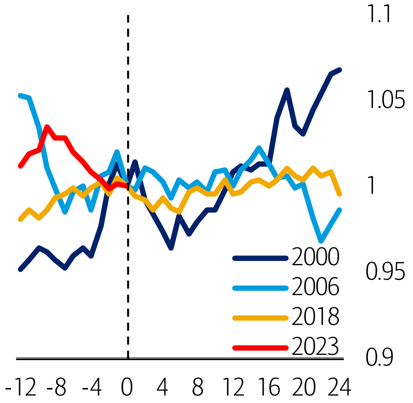
As seen in Exhibit 1, there is no obvious pattern of the dollar over the full course of the pause period, as each cycle saw the USD perform differently during the span of time Fed funds sat at its terminal rate. To compare the more medium-term price response, Exhibits 2, 3, and 4 show indexed changes in the DXY, GE-US IRDs, and the S&P500, 24 weeks from the last hike of the cycle. Net DXY moves in this timeframe were modest in all cases, with the most notable being the 2000-2001 episode, which saw the dollar depreciate initially, only to rally a few months out as equities sold off. The 2006-2007 USD selloff accelerated towards the latter part of the notably longer pause period. Nevertheless, in each instance, interest rate differentials, as proxied by the 2Y German-US sovereign spread, moved steadily against the dollar, as UST yields declined.

Exhibit 2: DXY performance 24 weeks from each pause
Net USD movements relatively limited in 2 of 3 periods



Source: BofA Global Research, Bloomberg

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Exhibit 3: GE-US 2Y IRD: 24 weeks from each pause
rate differentials moved against the USD in each 3 pause periods

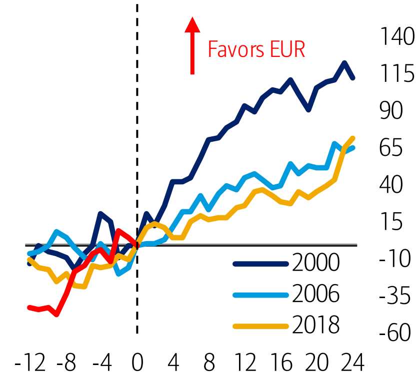

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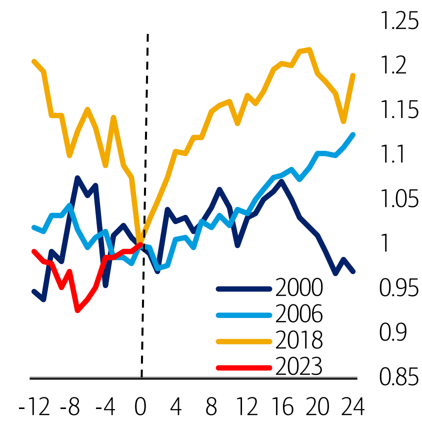
Exhibit 4: S&P performance 24 weeks from each pause
Stocks supported in early weeks of a pause



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2000-2001: Tech Bubble

In the 2000-2001 episode, the Fed was on hold for eight months (May 2000 – Jan 2001). The dollar was mixed, on net, against G10 currencies over this period, with the DXY just 1% lower from hike to cut (Exhibit 5). The dollar's path fluctuated during this timeframe, as it depreciated initially as the hiking cycle ended, then rallied during most of the hold period, before reverting.

The performance of US equities during this time was dissimilar to other pauses in hiking cycles, as the S&P declined ~8%, and the NASDAQ declined ~30% on the bursting of the tech bubble. This was likely a larger factor in the dollar's outperformance against some higher-beta G10 (and EM) currencies at the time. The EUR and other currencies in the region outperformed at the onset. The EUR came off of its lows (since introduction in 1999) immediately after the last Fed hike, but continued to trend lower during the period on euro-specific factors, which ultimately prompted the supportive G7 coordinated intervention in September 2000 (Exhibit 6).

Exhibit 5: DXY indexed to last hike & Fed Funds: 2000-2001 episode
Dollar varied over period; little changed on net

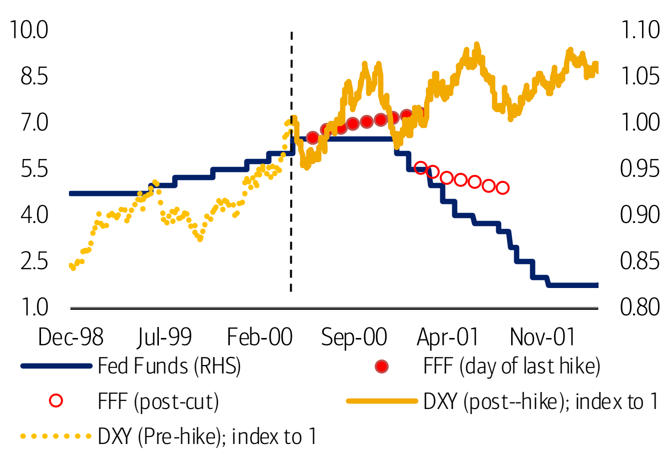

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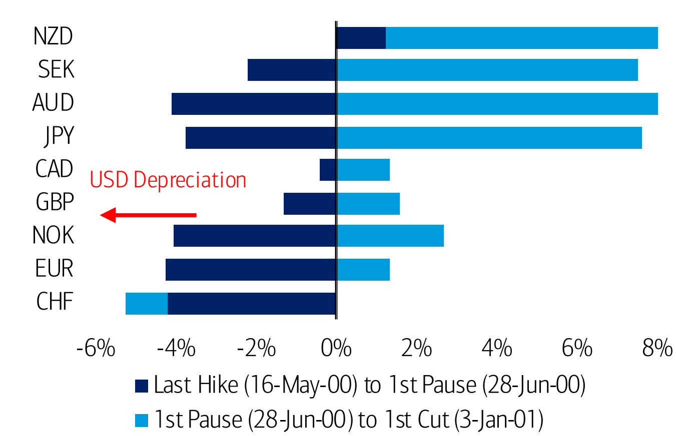
Exhibit 6: G10 FX performance: 2000-2001 pause period
USD mixed vs G10 during period; depreciated from last hike to first pause



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2006 – 2007: Pre-GFC

The second hiking cycle of the century came to an end ahead of what later became the Great Financial Crisis in 2007/2008. The USD's performance during this pause period (from Jun 2006 - Sep 2007) was starkly different to that of 2000-2001 (Exhibit 7). In the early stages of the pause-period, the dollar mostly traded sideways, though was ultimately weighted down by re-pricing of Fed expectations, which were still priced for further hikes at the time of what turned out to be the last hike. Equity markets were buoyed during the period (S&P500 +20%), and along with the USD, the worst performing currencies were the other traditional "safe havens"- CHF and JPY (Exhibit 8).

Growth divergence amongst the US and other global economies was a theme during this time, particularly into the later stages of the pause period and into the cutting cycle as emerging US housing weakness later became the epicenter of the crisis. Crude oil was rising notably during this time, keeping the ECB "vigilant" against inflation, contributing to the 170 basis points shift in rate differentials in favor of the euro. The dollar did not start appreciating until the crisis intensified in Q3 2008.

Exhibit 7: DXY indexed to last hike & Fed Funds: 2006-2007 episode

Dollar depreciated over pause period

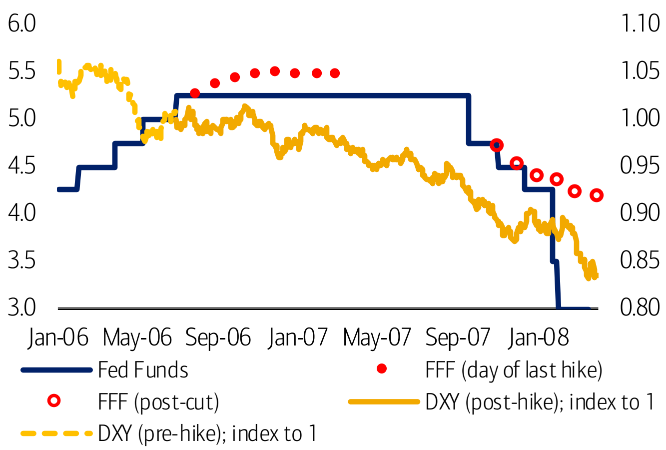

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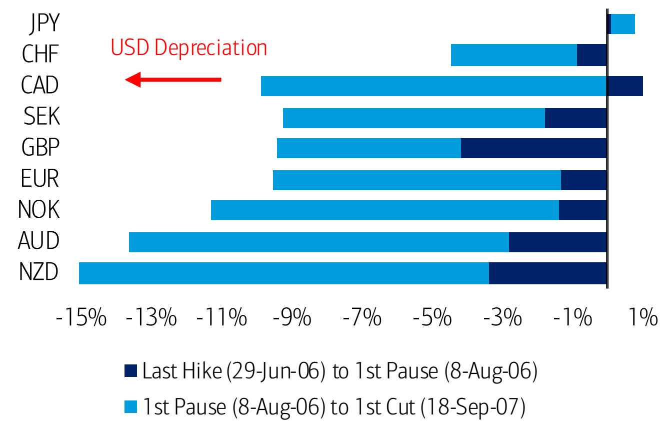
Exhibit 8: G10 FX performance: 2000-2001 pause period

USD mixed vs G10 during period; depreciated from last hike to first pause



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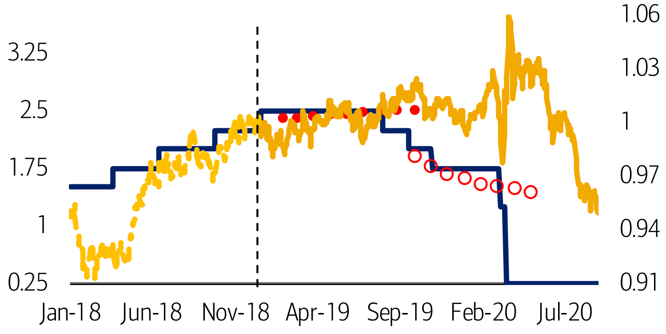
2018-2019: Trade Tensions

The last pause period was the shortest of the three (lasting seven months, from December 2018 to July 2019) and saw the DXY appreciated a modest 1.5% on net (Exhibit 9). Bi-laterally among the G10, the dollar was only lower against the JPY and CAD during the period (Exhibit 10). Most of the dollar's downside occurred between the last hike and the first pause, as US policy expectations were reassessed. Conditions in the US were mostly benign at this time, with the Fed citing "muted inflation pressures" as the reason to be "patient" with regards to future policy adjustments.

Trade tensions between the US and China cast a pall over the global outlook around this time, and global growth concerns led to more dovish policy outlooks among several G10 central banks. The dollar was on a multi-year trend appreciation path at the time and would continue to do so until the aftermath of the COVID19 shock in 2020.

Exhibit 9: DXY indexed to last hike & Fed Funds: 2018-2019 episode
Dollar slightly higher over pause-period



Source: BofA Global Research, Bloomberg

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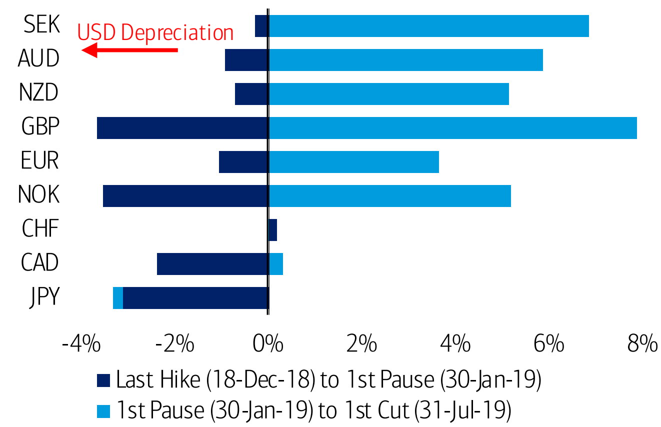
Exhibit 10: G10 FX performance: 2000-2001 pause period
USD mixed vs G10 during period; depreciated from last hike to first pause



Source: BofA Global Research; Bloomberg

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What's in store for 2023

The most glaring difference between these past instances and the current environment is the global inflation situation, and the generally synchronized hiking that has taken place among most G10 central banks. As we continue to suggest, the market's pricing of a quick pivot to Fed cuts in 2023 seems unrealistic and out of sync with the FOMC's stated commitment to bringing down inflation. Moreover, should the cuts materialize as priced, it most likely suggests that an economic hard landing is afoot, and/or financial stability related market turmoil has picked up markedly. In these scenarios, it seems likely the other major central banks with a tightening bias (ECB, BOE, etc) would likely adopt a more cautious approach as well. Early signs of this may be emerging, with the ECB's downshift to 25bp hike increments, but time will tell (see report: Euro Area Watch: ECB Review: still more ground to cover 04 May 2023). This and the potential for market de-risking may not necessarily be dollar negative over time, but it is still early. A common thread to past pause periods has indeed been dollar depreciation at the onset, but the direction is less clear over the full duration of the rate hold.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- Market concerns and FX implications, **Global FX Weekly**, 5 May 2023
- Deposits, Data and Debt**, Global Rates Weekly**, 5 May 2023
- Ahead of a busy week, **Liquid Cross Border Flows**, 2 May 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: Market concerns and FX implications 05 May 2023

Global Rates Weekly: Deposits, Data and Debt 05 May 2023

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