Liquid Insight

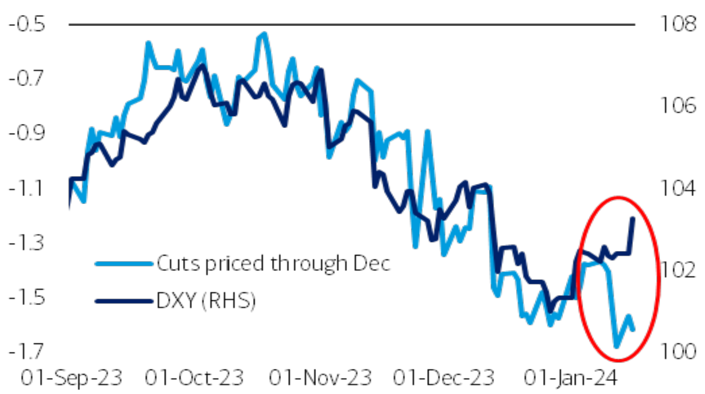
USD: Defying gravity

Key takeaways

- The USD is off to a hot start, appreciating vs the G10 despite more aggressive pricing of Fed easing for 2024
- Factors include: over-exuberant cut pricing, mixed US data, similar int'l CB pricing, balanced Fed comms, and geopol. risks
- We still forecast USD depreciation in '24 (beyond consensus), but its more of an H2 story; scope for 2-way risk in near-term

By Alex Cohen

Chart of the day: DXY and Fed cuts priced through Dec 2024
While dovish Fed pricing has continued this year, the USD has rallied



Source: BofA Global Research; Bloomberg

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USD off to a hot start

Despite greater pricing for Fed cuts to start the year, the USD has rallied against all G10 currencies. We see several reasons for this, including: the exuberant "pricing to perfection" of a soft landing scenario and the possibility that any cuts priced for a harder landing scenario are not USD negative; a mixed reading of recent US labor and inflation data; recent Fed communication striking a more balanced tone than the December FOMC; the fact that other central banks are similarly (albeit more modestly) being priced for faster/deeper easing in 2024; and ongoing geopolitical concerns.

While we see the USD depreciating broadly this year, it could still take some time, and our forecasts call for greater moves in H2. Current Fed pricing is excessive, but a normalized inflation environment and eventual rates cuts should still allow for greater FX valuation adjustments to finally occur, even as most other central banks are also cutting. But until we get even more signs that inflation is comfortably pointing towards central bank targets, the timing and pace of USD depreciation can remain less certain.

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Rates and Currencies Research
Global

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USD moving opposite of further Fed cut pricing

A funny thing happened on the path to further dovish Fed pricing this year- the USD has rallied (Chart of the Day). Indeed, the USD has outperformed all G10 currencies thus far in January, and is essentially trading just shy of levels prevailing just prior to the Fed's "dovish" December meeting (Exhibit 1). Meanwhile, the pricing of cuts has extended, both in terms of likelihood of the first cut (currently ~70% for March) and the depth of cuts this year (~160 bp through Dec 2024).

While FX price action is a bit puzzling in the context of added cut expectations, we see a few possible reasons, in no particular order, for the USD's recent consolidation.

- **Soft landing, "Priced to perfection"?**: The soft landing narrative has become consensus, possibly encouraged by the Fed's own SEP forecasts. The pricing of Fed cuts reflects the view that inflation will indeed come down in a way that soon makes the Fed comfortable with lowering the fed funds rate in lock step, in order to prevent the passive tightening of rising real rates. The first order of this (through December 2023) has been USD negative but is there seems to be a limit to this, absent greater disinflation signals.

  At the same time, "no landing" calls have moderated notably, while "hard landing" signs have still yet to emerge in the data. That said, perceived aggressive pricing of Fed cuts likely reflects some probability of a deeper and faster cut trajectory in response to a pronounced growth shock. Viewing markets through this lens, added Fed cut probability is not necessarily USD negative, at least at the onset, as the expected decline in risk assets during a growth shock would correspond with USD appreciation.

- **Mixed/inconclusive data**: Recent top-tier data has painted a mixed picture in the US in recent weeks. Headline employment and CPI readings have printed to the upside, while some of the sub-components have pointed to more softness. Components that pass-through to PCE— the Fed's preferred measure—appear to be on the soft side of the spectrum, though 2023 CPI revisions released next month will be highly relevant in shaping the Fed's outlook, as Fed Governor Waller recently noted. (US Economic Weekly: One step closer 12 January 2024)

- **Fed communications**: Fed communication subsequent to the December FOMC (both official speakers and the FOMC minutes) has generally struck a more balanced tone compared to the "dovish" communication at the December FOMC. This seems to have gained more traction in currency markets than short-term rates, prompting the USD to consolidate after sharp monthly declines in November and December.

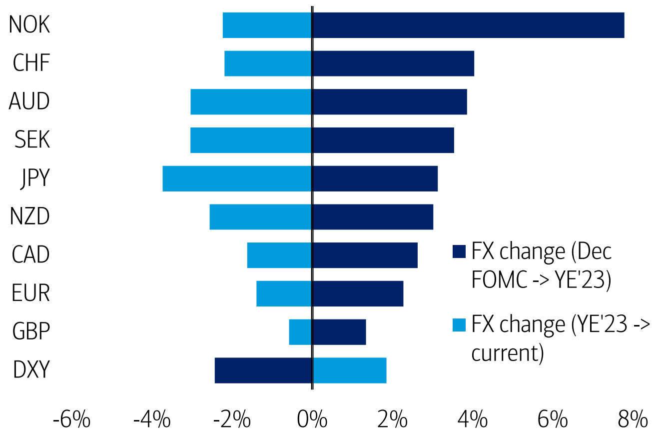
- **The other side of the (central bank) coin**: While pricing in of added cuts for the Fed has been led by the US (US 1y1d swaps have declined appx. 70-75 bp since the Dec FOMC), disinflation and further easing expectations have not solely been a US phenomenon. As seen in Exhibit 2 similar pricing for the RBA and ECB has added about 25 bp of cuts to 2024, despite little indication from officials that point in a such a dovish direction. Similarly, pricing for the RBNZ, BOC, and BOE during this time have added closer to 50bp of cuts. While the directionality of these shift in differentials is broadly consistent, specific bi-lateral currency changes not necessarily lined up with this pricing, suggesting more indiscriminate moves at the onset. This has mitigated some of the direct impact of Fed pricing on the USD.

- **Geopolitics**: Geopolitical risks have undoubtedly captured attention of the markets, but evidence of a widespread and direct translation to asset prices has been elusive. Nevertheless, in the current context, rising geopolitical risks should in theory be USD positive, due to safe-haven demand and less growth-sensitivity to any rise in energy prices emanating from conflict in the Middle-East. Indeed, while we see escalation of fighting in the Red Sea as having a modest but non-negligible impact on inflation pressures, the disruptions would pose a greater risk for Europe than the US. (Global Economic Viewpoint: Global rate cuts lost at (Red) Sea? 12 January 2024) This could speak to even further delayed cuts by the ECB than the Fed, all else equal, though the growth implications of such a stagflationary impulse would not necessarily benefit the euro, and others, vis-à-vis the USD.

- **A vol/hedging perspective**: Finally, our recent quantitative analysis points to signals for possible further USD upside in Q1, and suggests ways to hedge for such outcomes. (FX Viewpoint: Hedging a potential USD bounce in Q1 16 January 2024)

Exhibit 1: FX performance from Dec. FOMC to Year End '23 & from Year End '23 to current

The USD depreciated notably in the weeks following the December FOMC, though has mostly retraced thus far in 2024



Source: BofA Global Research; Bloomberg

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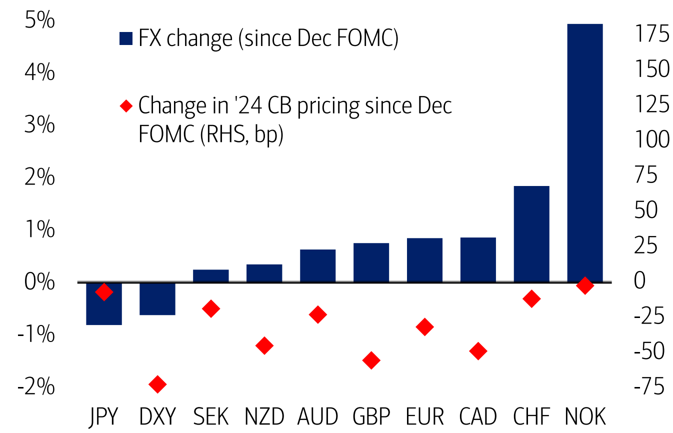
Exhibit 2: Spot FX changes (vs. USD) since December FOMC & changes in 1Y1D swaps

The USD has underperformed most G10 currencies (ex JPY) since the Dec Fed amid varied pricing of rate cuts



Source: BofA Global Research; Bloomberg

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A closer look at central bank pricing

We generally forecast the G10 central banks to deliver notably less rate cuts than markets currently have priced (Exhibit 3). In a recent publication, we even conducted the admittedly unrealistic but interesting thought exercise of contemplating the impact of no-rate cuts this year (Liquid Insight: Thinking the unthinkable: what if no central bank cuts rates this year? 16 January 2024)

This mismatch (of OIS pricing vs. our views) is most prominent for the BOE, ECB, Norges bank, Fed, Riksbank and RBA, where we see cuts undershooting market pricing by between 50 and 85bps. We see pricing more in-line with the market for the BOC and SNB, while RBNZ cuts should well exceed market pricing. The overall BOJ outlook, of course, remains well detached from the rest of the G10.

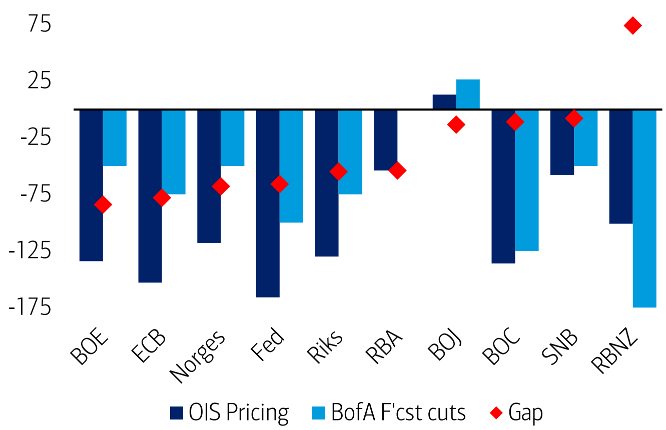
As noted above, this pricing of apparent market exuberance for rate cuts (relative to our views) likely also reflects some likelihood of a hard landing outcome. In this macro scenario, central banks would need to more dramatically cut rates by a greater magnitude than would be warranted simply to match further disinflation and the desire to prevent passive tightening from current levels. Should the general magnitude of market pricing turn out more right than wrong, the underlying cause could very well fit with a dollar positive environment, just for different reasons.

As for FX implications, we still see a narrowing of policy differentials in the direction of a shrinking carry advantage for the USD vs. all G10 currencies except the CAD and NZD (Exhibit 4). Relative to consensus, our forecasts for the change in policy differentials are mixed, with less forecasted narrowing (greater widening) in 2024 in the case of the CHF, EUR, SEK, as well as CAD and NZD as posing some risks to our forecasts to broad USD depreciation (discussed below).

Still, we don't view these discrepancies in-and-of themselves as a reason to be overly bullish the USD on the longer-term horizon, but more so that the near term could see more 2-way FX risks.

Exhibit 3: Central Bank Pricing for moves in 2024 (OIS) & BofA Forecasts

Market pricing for central bank cuts well exceeds most BofA forecasts for most of the G10



Source: BofA Global Research; Bloomberg; *RBNZ and Riksbank pricing reflects Nov 2024

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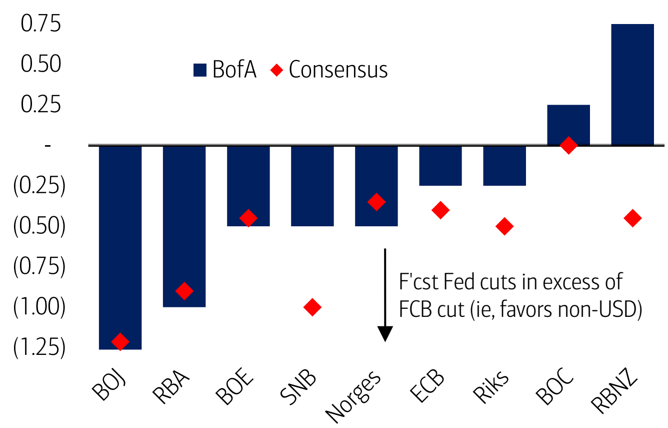
Exhibit 4: Forecasted change in central bank policy differential (Fed - FCB)

We anticipate the Fed's rate advantage to narrow this year vs. all except the BOC and RBNZ



Source: BofA Global Research; Bloomberg

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BofA FX Forecasts: USD depreciation to be backloaded in 2024

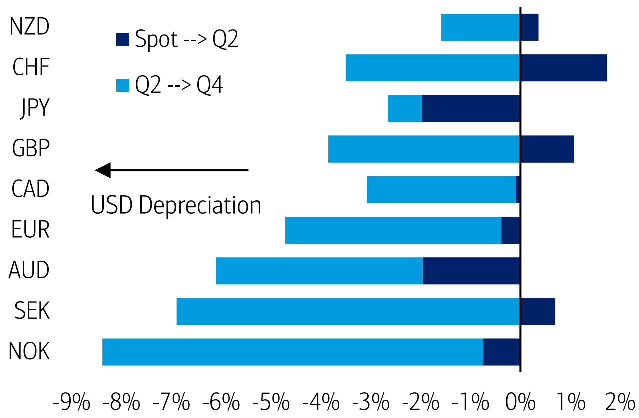
While we see the USD eventually depreciating broadly this year, it could still take some time. A normalized inflation environment and eventual rates cuts by the Fed should allow space for greater FX valuation adjustments to finally occur, even if most other central banks are also starting rate cutting campaigns. But until we get even more definitive signs that inflation is comfortably pointing towards central bank targets, the timing and pace can remain less certain.

As such, we envision a majority of the USD's expected depreciation this year to occur in the second half, after the Fed's and other central banks easing campaigns are clearly underway (Exhibit 5). The most notable stand-out exceptions to this are:

- AUD: Where we expect no-cuts this year, and a favorable structural backdrop against peak-pessimism in China.
- JPY: Where we see more 2-way near-term risks currency risks related to the expected removal of YCC/NIRP, amid a still notably unfavorable carry backdrop.
- CHF: Where Swiss inflation appears comfortably below target amid similar overvaluation to the USD.
- For a high-level view of individual currencies, see: FX Viewpoint: G10 FX: 24 Charts for 2024 15 January 2024

Overall, we see the USD ending the year weaker than consensus (Exhibit 6). In spite of aforementioned near-term risk factors, we still see a soft landing in the US as the more likely of the various outcomes (FX Viewpoint: G10 FX Year Ahead: The year of the landing 20 November 2023).This will ultimately pave the way for steady Fed cuts (and narrowing rate advantage) amidst a favorable environment for risk appetite. Indeed, the currencies we see performing the best this year are the higher-beta currencies (NOK, SEK, and AUD) whereas those that are notably disadvantaged from a carry perspective (JPY) or well underpriced for cuts (NZD) should lag from current levels.

Exhibit 5: BofA FX Forecasts: Implied USD move through YE 2024
We see 2024 as a year of USD depreciation, though mostly during H2



Source: BofA Global Research; Bloomberg

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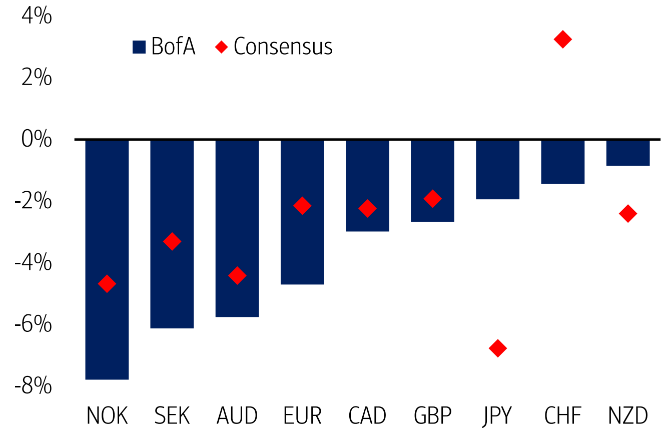
Exhibit 6: Implied USD move in 2024 based on BofA and Consensus forecasts
Our forecasts for broad USD depreciation 2024 are consistent but in excess of consensus for most G10 currencies



Source: BofA Global Research; Bloomberg

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Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **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
- USD breather, **Liquid Cross Border Flows**, 8 Jan 2024

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: The long and choppy rest of the year ahead 12 January 2024

Global Rates Weekly: Quantitative Teasing 12 January 2024

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