

Liquid Insight

Caution on disinflation for G10 FX

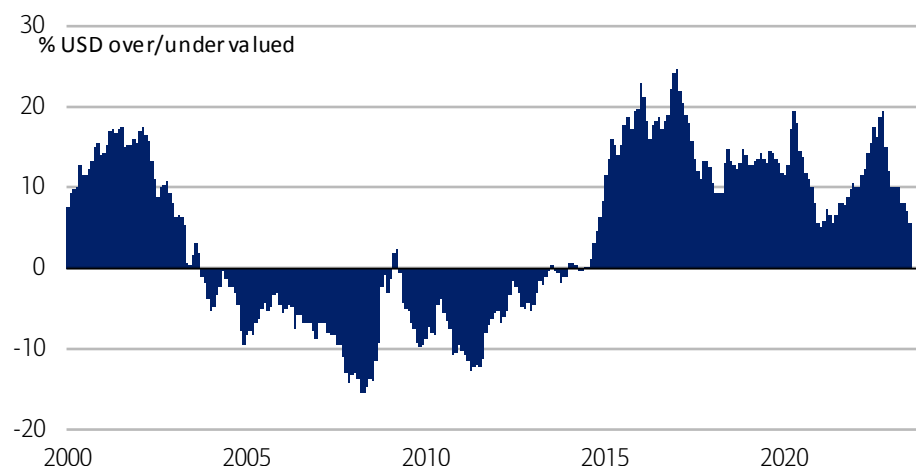
Key takeaways

- USD has sold off to begin Q3, but we continue to look for some reversal and keep our G10 FX forecast profiles unchanged.
- In particular, we continue to look for a year-end EUR-USD forecast of 1.05, while we also look for longer-term USD softening.
- While we see the USD as broadly overvalued, we remain cautious around the prospects for a disinflation with a soft landing.

By John Shin, Athanasios Vamvakidis and Alex Cohen

Chart of the day: USD is overvalued but we still expect more sustainable downside next year

USD is still moderately overvalued, looking at BIS real effective exchange rate against past decade



Source: BIS, Bloomberg and BofA Global Research

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Caution amid optimism for a soft landing

The beginning of Q3 has opened up with renewed optimism around reaching a soft landing for the US economy, and in particular, achieving a relatively speedy reduction in inflation without a sustained downturn after particularly better-than-expected numbers in recent CPI data. The possibility that price pressures may not be as sticky as expected has softened expectations for the Fed, and also led to USD downside to start the second half of the year. However, we remain wary of both the speed of disinflation as well as changing policy responses to the fight against inflation, and continue to look for USD upside this year. While we still see USD as overvalued, we still look for upside in H2.

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Source: BofA Global Research

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USD: down but not out as soft landing narrative takes hold

In the span of a week, market sentiment on the dollar seems to have shifted notably. The June CPI miss (and to a lesser extent, the mixed June employment report) has emboldened dollar bears, as the “soft landing”/“immaculate disinflation” narrative has moved to the forefront. This has driven the Bloomberg Dollar Index to its 15-month lows (Exhibit 1), after range trading during H1 (see report: [FX Watch: June \(CPI, NFP\) Swoon for the USD 12 July 2023](#)).

EUR: complexity in the downturn

In more specific terms, EURUSD appreciated from 1.07 at the end of May to 1.12. This is despite weak Eurozone data, particularly compared with that of the US (Exhibit 2), as well as a very weak recovery in China during re-opening. However, EUR crosses have weakened. Indeed, EUR is the third worst performer in G10 so far in July, after the USD and CAD. Therefore, recent EUR strength is just USD weakness, which in turn depends on the stickiness of US inflation and the Fed. Eurozone core inflation has been stickier than in the US and the ECB has been hawkish, which could in theory have also offered some support for the EUR, but weak data may have offset it. The consensus remains bullish EURUSD, re-engaging with longs whenever they see an opportunity.

Exhibit 1: USD & SOFR futures curve (Dec 24 - Sep 23)

Expectations for additional cuts drives USD to fresh lows

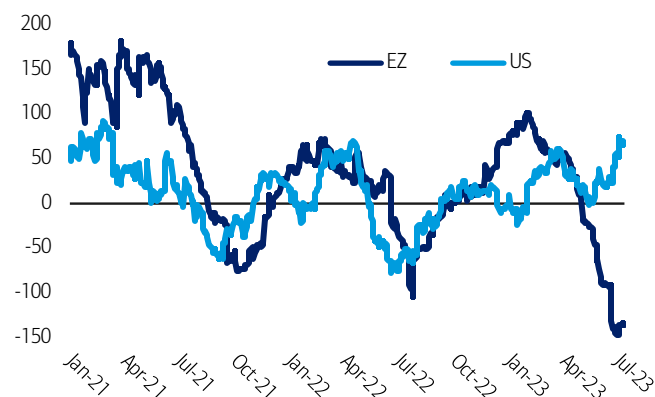


Source: Bloomberg and BofA Global Research

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Exhibit 2: Data surprises vs. consensus

Eurozone data has disappointed expectations recently, especially vs. US



Source: ECB and BofA Global Research

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The “soft landing” scenario is the least constructive for the dollar, as it brings forward expectations for Fed easing without a significant growth shock. As such, we view the recent dollar sell-off as directionally justified, yet likely excessive in magnitude. The CPI report has resulted in a pricing out of hikes this year (beyond July) and approximately two additional cuts being priced through 2024.

Dubious around near-term easing prospects

We are again dubious about the level of Fed easing being priced in, given the prospect that inflation – despite improvements – will remain sticky on the path to 2%. US data more broadly has continued to trend to the upside, driven by still tight labor markets, service sector growth and a housing market rebound. In contrast, growth data out of Europe and China has underwhelmed. This and the removal of base effects keep the prospect for core inflation resurgence alive.

We remain skeptical short term, as the Eurozone economy is doing much worse in relative terms and we see soft landing as the least likely scenario to bring inflation down. We are more constructive looking into next year, but once again it seems to us that the market has priced a too optimistic scenario of global inflation coming down too soon without much, if at all, economic pain.

Forecasts: unchanged despite repricing

Although upside risks to our bearish EUR short-term forecasts have increased following the latest price action, we stick to our view (see our G10 FX forecast profiles in Exhibit 3). It is mostly a USD call, as the EUR has been weak vs. the rest of G10. We continue to forecast EUR-USD at 1.05 for the rest of the year, appreciating to 1.15 by the end of next year, and towards long-term equilibrium at 1.20 by end-2025.

We would note that last month we did revise up our USD forecasts slightly (from 1.10 to 1.05 in EUR/USD and 140 to 145 in USD/JPY) on US growth outperformance, elevated US rates and sticky core inflation. Despite recent moves, we ultimately maintain these forecasts, seeing scope for the dollar to find support in H2, before depreciating towards fair value in 2024.

We also keep our European FX outlooks unchanged. In particular, we still have EUR-GBP focused around the 0.85 level through our forecast horizon. We similarly keep the view for Dollar Bloc the same as well, ultimately looking for strength against the overvalued USD.

Risks: downside forecast risks post USD selloff

Downside risks to our USD forecasts have clearly increased following the June CPI report, and subsequent sell-off. Data dependent central banks keep the market susceptible to the latest print, and further disinflationary signals would likely keep the dollar on the back foot, barring a major growth or market shock.

Unease over broader geopolitical and macro risks such as financial sector turmoil, China reopening, and the war in Ukraine have generally subsided from a markets perspective for now. But of course, there are also interactions among all those risks, such as how the surprisingly weak outlook in China has weighed on oil prices since their peak last year.

For the euro in particular, the EUR remains subject to the latest data prints in the Eurozone and in the US. A stagflation scenario could challenge the ECB and eventually lead to a hard landing. And relatedly, energy prices remain a potential staglatory sticking point.

Exhibit 3: G10 FX Forecasts

We still look for USD upside by the end of this year, with more sustainable downside in 2024 and after

	Spot	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
G3											
EUR-USD	1.12	1.05	1.05	1.07	1.10	1.15	1.15	1.16	1.17	1.18	1.20
USD-JPY	138	147	145	140	135	130	125	125	125	125	125
EUR-JPY	156	154	152	150	149	150	144	145	146	148	150
Dollar Bloc											
USD-CAD	1.32	1.32	1.30	1.30	1.29	1.28	1.26	1.26	1.26	1.26	1.26
AUD-USD	0.68	0.67	0.69	0.72	0.73	0.74	0.75	0.75	0.75	0.75	0.75
NZD-USD	0.63	0.61	0.62	0.64	0.65	0.66	0.67	0.67	0.67	0.67	0.67
Europe											
EUR-GBP	0.86	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
GBP-USD	1.31	1.24	1.24	1.26	1.29	1.35	1.35	1.36	1.38	1.39	1.41
EUR-CHF	0.96	0.98	0.98	0.99	0.99	1.00	1.00	1.02	1.02	1.05	1.05
USD-CHF	0.86	0.93	0.93	0.93	0.90	0.87	0.87	0.88	0.87	0.89	0.88
EUR-SEK	11.50	11.50	11.00	10.70	10.60	10.50	10.30	10.20	10.10	10.10	10.00
USD-SEK	10.24	10.95	10.48	10.00	9.64	9.13	8.96	8.79	8.63	8.56	8.33
EUR-NOK	11.34	10.90	10.60	10.40	10.40	10.20	10.00	9.90	9.80	9.80	9.70
USD-NOK	10.09	10.38	10.10	9.72	9.45	8.87	8.70	8.53	8.38	8.31	8.08

Forecast as of Jul-18-2023. Spot exchange rate as of Jul-18-2023. The left of the currency pair is the denominator of the exchange rate.

Source: BofA Global Research

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023** – [Year Ahead 2023: Pivot ≠ Peak](#), 20 Nov 2022
- [Carry resurrection; the reports of its death were greatly exaggerated](#) **Global FX Weekly**, 14 July 2023
- [Price is right](#) **Global Rates Weekly**, 14 July 2023
- [To carry or not](#), **Liquid Cross Border Flows**, 10 July 2023

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