FX Viewpoint

Various landing scenarios & the USD

01 March 2023

G10 FX Strategy
Global

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Key takeaways

- Debate over landing scenarios (hard, soft, no) continues; which one is realized will determine the USD's direction this year.
- We see 2 of the 3 scenarios (hard and no landing) as constructive for the USD, posing upside risks to our USD forecasts.
- A soft landing should see the USD's depreciation trend resume, as policy rates decline amid constructive risk appetite.

How will we land?

Challenging inflation and growth dynamics point to rising policy uncertainty as the global monetary tightening cycle matures. As the data has evolved, so too has the debate over which landing scenario will ultimately come to fruition later this year: "hard landing," "soft landing," or "no landing." Each one presents notably distinct economic conditions, with differing implications for the dollar. We see two of these three scenarios as constructive for the dollar, posing upside risks to our USD forecasts.

Soft landing: Does not bode well for the USD

While definitions may vary, a "soft landing" would essentially see gradual dis-inflation in concert with the monetary tightening currently in the system already, while a broad recession would be avoided. Payroll growth would likely decline but remain positive, and no wage-price spiral would materialize. Here, the USD would likely resume its downtrend observed during Q4 2022 and January 2023.

Hard landing: USD to be supported as risk assets decline

A "hard landing" implies a recession, potentially a deep one. Here, inflation could either decline along with activity or stay uncomfortably elevated on lingering structural/supply-related factors. While the specific economic conditions (and the Fed's reaction function) will be telling, the dollar would likely find support amid elevated volatility and risk aversion.

No landing: Here but for how long?

US data releases in February have been clear – the labor market is still tight, and disinflation is not a straight line. Fed expectations have re-priced higher, and the USD has rallied accordingly. While this "no landing" scenario likely implies either a hard or soft landing down the road, the longer it persists, the better the dollar should do.

DXY = US Dollar Index

FRBNY = Federal Reserve Bank of New York

PMI = Purchasing Managers Index

FRBNY = Federal Reserve Bank of New York

Refer to important disclosures on page 10 to 11.
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Timestamp: 01 March 2023 01:00AM EST

Various landing scenarios and the USD

The dollar has performed a hard U-turn to start the year, as a wave of upside US data has injected uncertainty over which path of inflation and growth will be realized and how the Fed will respond.

Challenging inflation and growth dynamics point to rising policy uncertainty as the global monetary tightening cycle matures. As the data has evolved, so too has the debate over which landing scenario will ultimately come to fruition later this year. These can generally be bucketed into A) "hard landing," B) "soft landing," and the emerging C) "no landing" scenarios. Each one presents notably distinct economic conditions, with differing implications for the dollar.

While market consensus and our own forecasts (see the report, World at a Glance: The Hot Winter 22 February 2023) call for the dollar to depreciate later this year and next, the current economic backdrop suggests potentially more upside risks to our forecasts into 2H 2023, as two of these three scenarios would likely be constructive for the dollar.

How we got here

The reasons for the dollar's decline from cyclical highs in the fall of 2022 are justifiable. Passing peak inflation in the US amid China reopening and improved economic and energy prospects in Europe has served to notably reduce the risk premium that supported the dollar in 2022. Global energy prices have fallen, and supply chains have thawed. And financial market volatility across FX, rates and equities has reduced. As far as currency markets are concerned, as we move further into 2023, these factors will likely have diminished impact on price action, particularly as new risks emerge.

Among the most influential factors for the dollar has been the evolution of inflation and the concurrent assessment and impact of Fed policy. Passing peak inflation saw a market narrative evolve from the Fed "pivoting" to a smaller magnitude of hikes, to "pivoting" to a possibly lower terminal rate, to "pivoting" to expected rate cuts in H2 2023. As the magnitude of Fed hikes declined from 75 to 50 to 25 bp increments, so too did the dollar.

The dollar's recent low corresponded with the February Federal Open Market Committee (FOMC) press conference, where markets latched on to Chair Powell's lack of pushback on market pricing, his clear recognition of deflationary forces, and a step back from rigid "higher-for-longer" forward guidance. Since that time, however, top-tier US data surprises have served to remind the market that passing peak inflation is not the same as a straight-line move to the 2% target. Both pricing and the dollar have adjusted higher accordingly.

A closer look at the landing scenarios

As noted, the three broad scenarios of "hard," "soft," or "no" landing pose different paths for the dollar. While stopping short of taking on the fool's errand of prescribing hard probabilities to each one, looking at them in turn can nonetheless be helpful in framing possible outcomes for the dollar later in the year.

The following table (Exhibit 1) summarizes the general characterization of these scenarios and their possible implications for the Fed, risk assets, and the dollar.

Exhibit 1: "Soft," "hard," and "no landing
Hard and no landing should be constructive for the USD

Scenario	Growth	Inflation	Fed Policy	Risk Asset Performance	USD
Soft Landing	Lower growth but recession avoided; payrolls remain positive	Gradual disinflation towards 2%	lower terminal rate; pivot to rate cuts	Supported on 'no recession' and monetary easing	Declines on better risk appetite and lower rates
Hard Landing	Recession; negative payroll growth	Either a) persistent (stagflation) or b) disinflation with decreased activity	Faster pivot to rate cuts	Entering recession weighs on risk assets	Despite rate cuts, dollar appreciates on broader 'risk off'
No Landing	Activity remains robust; payroll growth elevated	Remains sticky on the way down	"Data dependent" stance keeps policy tighter for longer	Opposing forces: risk supported by growth resilience; weighted on by higher rates and potential hard landing	Supported by higher rates and increased probability of risk aversion down the road

Source: BofA Global Research

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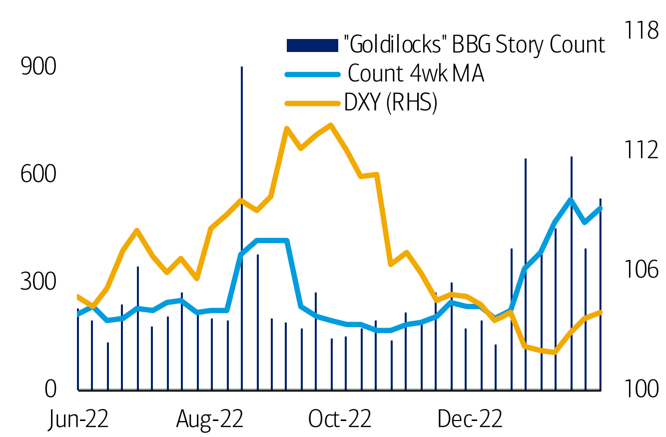
A soft landing:

Bodes well for risk assets, not so much the USD

A soft landing (so-called "Goldilocks" in market parlance) would likely be the most constructive for risk assets and least constructive for the dollar (Exhibit 2). Here, the inflation situation more or less works itself out gradually, along with the monetary tightening currently in the system already, and broad recession is avoided. Payroll growth declines but remains positive, and wage pressure is alleviated, thus ensuring that a wage-price spiral is avoided.

Arguably, this was a prevailing or at least growing base case for markets at the start of the year (before the clear surge in US data). Equities rose ~9% over the first 5 weeks of the year, Treasury yields were relatively rangebound, and the dollar (DXY) declined to cyclical lows (Exhibit 3).

Exhibit 2: BBG's "Goldilocks" story count & USD
Dollar depreciates amid January soft-landing narrative



Source: BofA Global Research, Bloomberg. BBG = Bloomberg. 4w MA = 4-week moving average.

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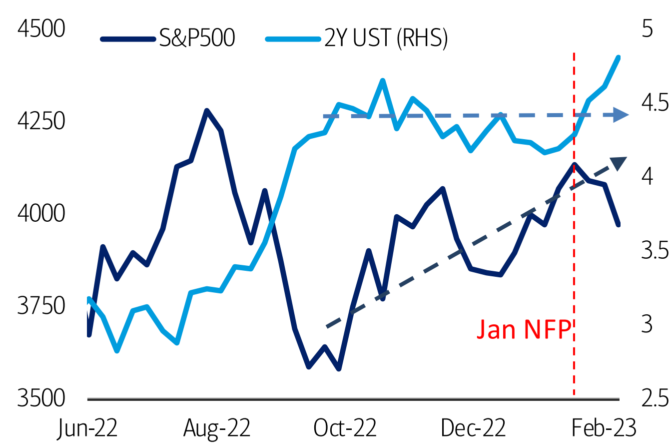
Exhibit 3: S&P 500 & 2Y UST
Steady rates and rising equities in Q4 2022 and early 2023



Source: BofA Global Research, Bloomberg. Y = year. UST = US Treasury.

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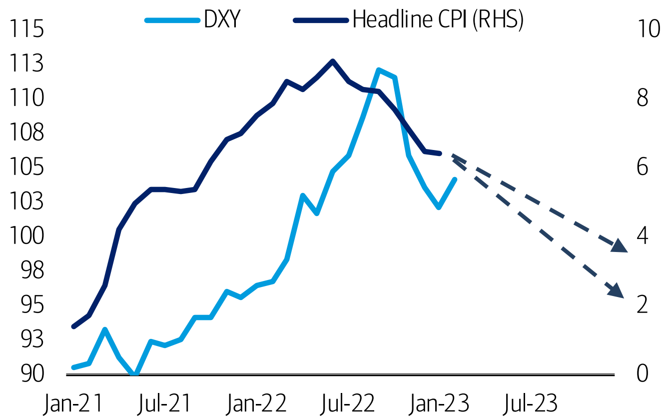
Assumes steady disinflation...

From an inflation perspective, realization of a true soft landing would arguably correspond with inflation trending down towards the 2-3% range sometime towards the end of the year (Exhibit 4). In this scenario, using the current 5.27% market-implied Fed Funds effective rate for the December 2023 FOMC meeting date would produce a real effective Fed Funds rate of roughly 2-3%. By today's conventional wisdom, this would be seen as still highly restrictive, as the Fed continues to assess the long-run Fed Funds rate (nominal) at 2.5%, implying a real neutral rate of 0.5%. As inflation peaked, expectations for a soft landing are one reason why the market was pricing rate cuts from the terminal rate in H2 2023 (Exhibit 5). Much of the dollar's decline since October, and many forward-looking derepcaiton forecasts, were predicated on this scenario. However, as Exhibit 5 shows, these cuts have been pushed further out, and terminal has repriced higher, suggesting reduced expectations for steady disinflation.

Exhibit 4: CPI & DXY

Steady inflation decline likely to correspond with dollar depreciation



Source: BofA Global Research, Bloomberg. CPI = Consumer Price Index. DXY = Dollar Index.

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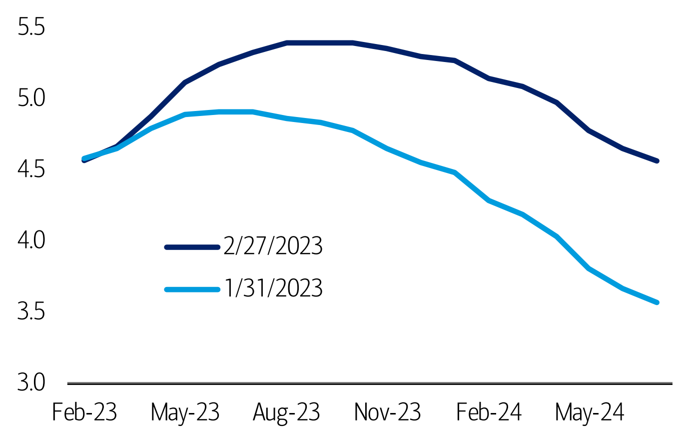
Exhibit 5: Fed Funds futures curve

Rapid Fed cuts from terminal priced to start the year; gradually pushed out since



Source: BofA Global Research, Bloomberg

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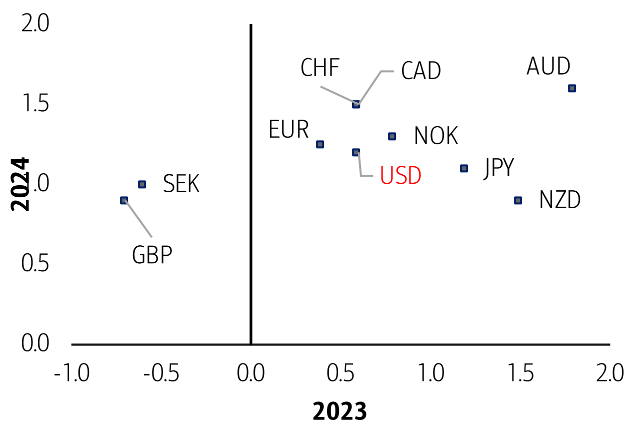
... And low but non-recessionary growth

From a growth perspective, soft landing scenarios continue to be reflected in economic forecasts to a large degree. Looking at gross domestic product (GDP), this is evident not just for the US but for many other G10 economies as well. Median real GDP projections for 2023 and 2024 suggest expectations for positive real growth for all G10 countries in 2024 and in 2023, for all except the UK and Sweden, countries where various structural and cyclical headwinds are prevalent (Exhibit 6; see also the reports, FX Viewpoint: GBP in 2023: More of the same? 13 February 2023 and FX Viewpoint: SEK in 2023: threat now, opportunity (maybe) later 12 January 2023). Countries where GDP forecasts are the highest – perhaps unsurprisingly – are those with greater proximity to China (Japan, Australia, New Zealand). This is consistent with the "China reopening" theme, which was also a notable factor bringing the dollar lower in Q4 2022.

Unemployment forecasts, however, paint a more mixed picture. For some economies (the Euro area, Switzerland, and Japan), forecasts call for little or only a moderate rise in the unemployment rate from current levels into 2024, while other countries do not look as favorable. Here, the US does stand out, as 2024 median forecasts imply a rate of 4.8%, higher than the current, albeit historically low, reading of 3.4% (Exhibit 7). However, as relates to the dollar itself, this is likely a supportive factor, given the dollar's inverse relationship with risk – i.e., the other half of the "dollar smile" (see below).

Exhibit 6: Consensus growth projections
Modest but positive growth projections for most countries in 2023 & 2024



Source: BofA Global Research, Bloomberg

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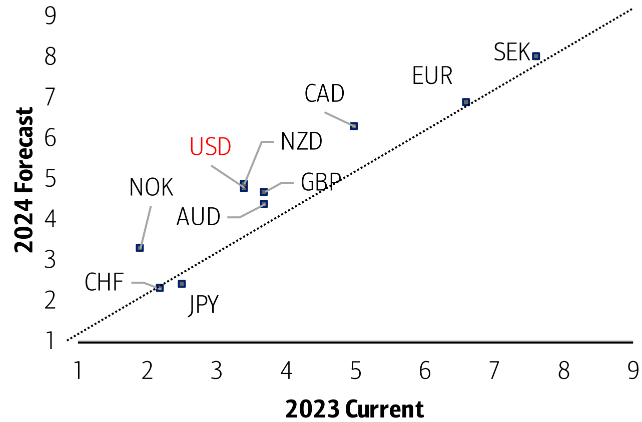
Exhibit 7: Current unemployment versus consensus projections
US unemployment expected to rise in 2024



Source: BofA Global Research, Bloomberg

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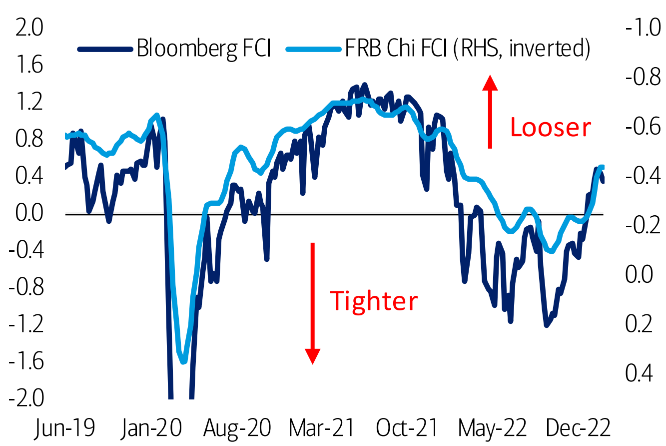
Risks to a soft landing are... a hard landing, of course

One plausible way that a soft landing can become a hard one is the financial conditions virtual (vicious?) circle. Financial conditions have long been cited by Fed officials as an essential watchpoint. Too loose financial conditions (buoyant equities, easy credit, weak dollar, etc.) introduce challenges to fighting inflation, as they can serve as a catalyst for upside wage pressure. While Chair Powell has frequently cited the net tightening in financial conditions over the past year in the Fed's attempt to rein in inflation, the looser trend over the past few months should speak to an even tighter policy stance as inflation expectations rise, all else equal (Exhibit 8). Indeed, minutes to the February FOMC meeting indicated that "a number of participants observed that financial conditions had eased in recent months, which some noted could necessitate a tighter stance of monetary policy." Thus far, market-based measures of inflation expectations remain relatively anchored, though implied rates based on US inflation swaps have crept up recently amid upside US data surprises (Exhibit 9).

Exhibit 8: US financial conditions
Financial conditions starting to ease, following notable tightening over past year



Source: BofA Global Research, Bloomberg

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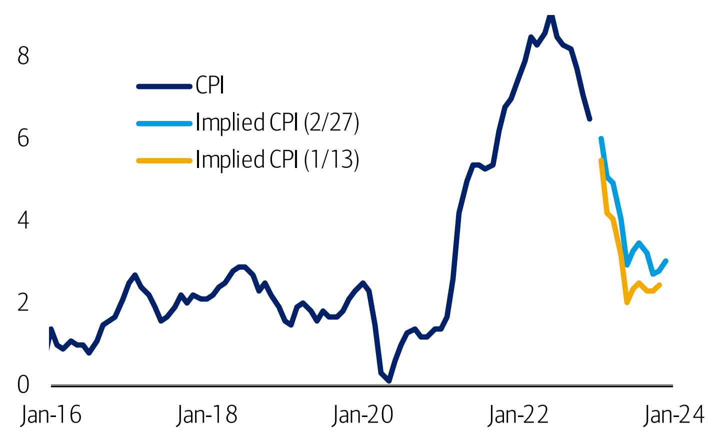
Exhibit 9: CPI & inflation swap pricing
Market-implied inflation expectations contained yet creeping higher



Source: BofA Global Research, Bloomberg

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A hard landing:

Could see differing inflation paths...

In a hard landing, the ultimate path of inflation is more ambiguous. In one state of the world, the Fed hikes (and subsequently cuts) generally in line with its stated guidance/market expectations. Here, inflation and aggregate demand both roll over concurrently, as monthly payrolls start to trend negative, and growth data reflects further contraction. Deeper rate cuts are realized in this environment, which would only partly weigh on the dollar to the extent that they are not offset by similar cuts abroad and broad risk aversion.

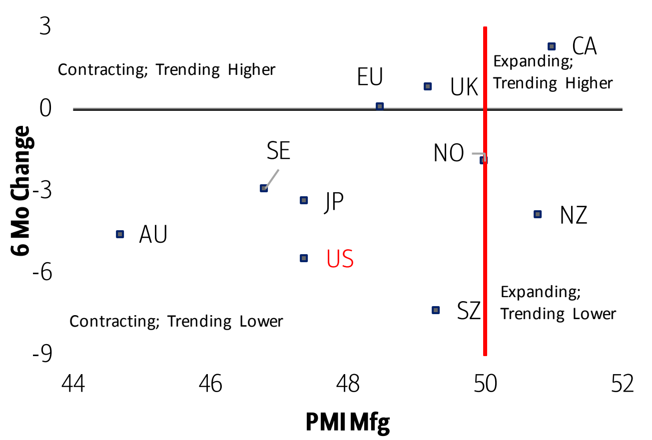
Another possible path, and one that is even less desirable is where inflation remains highly sticky for more structural or supply-side reasons. This scenario would present clear policy challenges for central banks. A Fed committed to bringing inflation down would need to keep rates at restrictive levels, potentially even more that is currently priced. This would likely be done to bring the labor market into balance in a more concerted way, potentially forcing an even deeper recession.

...As growth contracts

While not portending a hard landing in and of itself, global Purchasing Manager Index (PMI) data does suggest that some recessionary forces are at play. Contractionary conditions (sub-50 reading) in manufacturing PMIs are prevalent for all G10 economies, except Canada and New Zealand, and all but Canada have been trending lower over the past 6 months (Exhibit 10). In contrast, services PMIs imply expansion in each economy, except Australia and the UK (Exhibit 11). While this dichotomy implies more balanced activity, it clearly introduces difficult tradeoffs for central banks. With inflation driven by the services sector, tighter monetary policy responses would still serve to further tighten manufacturing activity, all else equal.

Looking at a broader set of economic supports this view. In our report ([Liquid Insight: One-of-a-kind recession 13 February 2023]), we show that leading indicators have now turned negative for the first time since COVID. Historically, this has led to negative QoQ GDP 90% of the time, along with a clear dollar uptrend over the ensuing 12-month horizon.

Exhibit 10: G10 Manufacturing PMIs
PMI Manufacturing readings sub-50 and trending lower in most G10 economies



Source: BofA Global Research, Bloomberg

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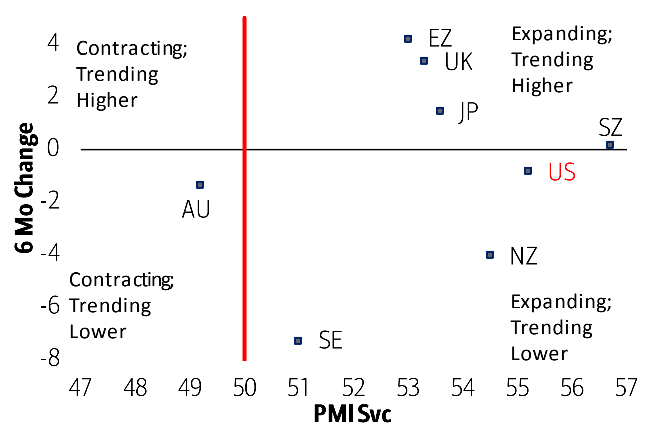
Exhibit 11: G10 Services PMI
PMI Services readings above 50 in most G10 economies



Source: BofA Global Research, Bloomberg

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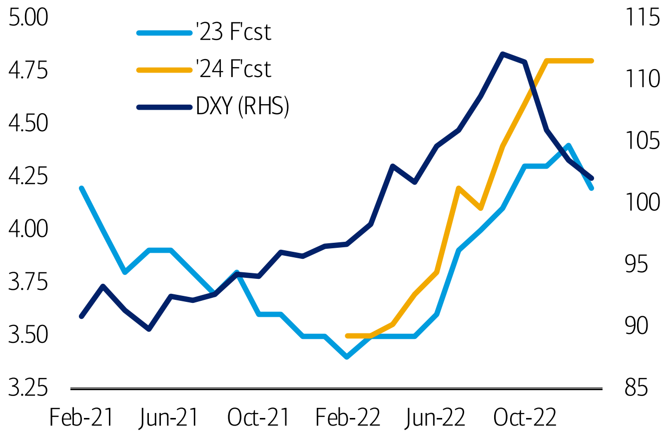
With the USD supported regardless

Indeed, irrespective of the inflation path, flight to safety and liquidity would be a sizable tailwind for the dollar on net, despite the potential for a drop in interest rates. This assumes that such a state of the US would be felt similarly, if not more severely elsewhere (i.e., no "decoupling"). As forecasts for future US unemployment have risen (see discussion above), so too has the dollar (Exhibit 12). Policy uncertainty and presumable financial market volatility would clearly correspond to dollar strength (Exhibit 13).

Exhibit 12: DXY & US Unemployment Forecasts
As unemployment forecasts rise, so too does the dollar



Source: BofA Global Research, Bloomberg

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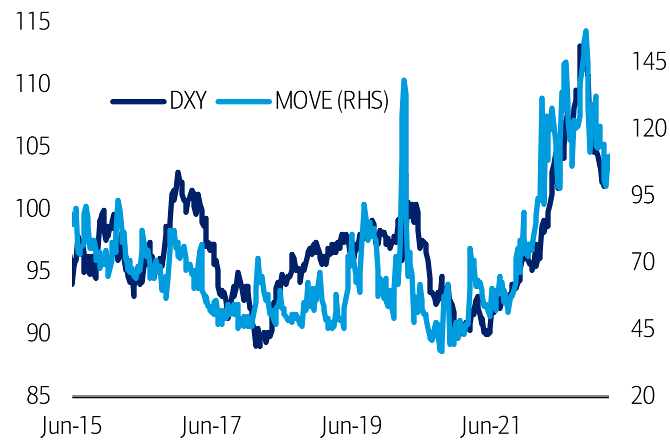
Exhibit 13: DXY and MOVE Index
Policy uncertainty, as measured by rate volatility, benefits the dollar



Source: BofA Global Research, Bloomberg

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Hard landing could bring back "Fed put" and/or further fiscal support

A hard landing scenario would likely see the Fed cut rates significantly in an attempt to steer back towards a soft-landing outcome. In this scenario, perhaps the more significant risk factors would be more long term and structural in nature. Depending on the state on inflation, Fed (and other central bank) credibility could come into question, if they are seen as choosing to set policy more in line with the "Fed put." Preserving inflation fighting credibility would entail relatively tighter policy, risking an even deeper recession down the road. Elsewhere, a hard landing raises the potential for even more fiscal stimulus on top of what is already viewed as a relatively loose stance, which likely would not be as constructive for the dollar, all else equal.

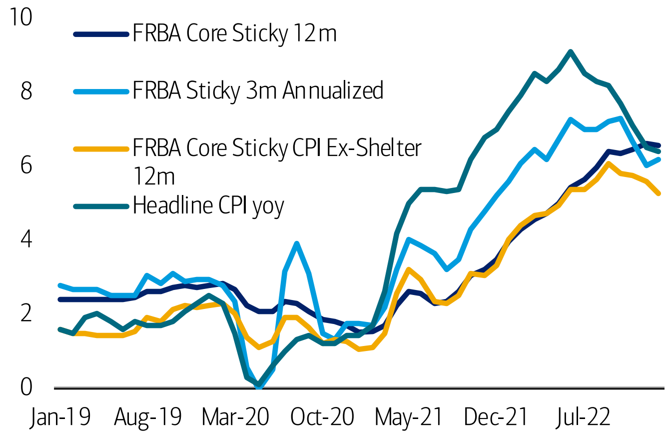
No landing:

Here but for how long?

Finally, a scenario getting a lot of attention recently, mainly due to recent signs of US economic resilience, is the "no landing" scenario. Here, inflation stays elevated or declines only modestly, while activity and employment data remain elevated, even amid more aggressive Fed policy. However, "no landing" is possibly a misleading term in relation to the others. Unlike "soft" and "hard" landings, "no landing" arguably refers to the journey, rather than the destination. One could safely assume that it would only be a matter of time before either inflation is forced lower or a policy-induced recession emerges. Or both.

Headline and core Inflation has declined, of course, but has thus far been uneven and sticky. As has been widely noted, going from, say, 6% to 4%, for example, is much easier than going from 4% to 2% – particularly when energy has already fallen significantly and the beneficiary impulse from thawing of supply chains has mostly occurred already. As Dallas Fed President Logan recently remarked, "Supply chains can't recover twice, so I don't see 3 percent deflation in core goods as sustainable." The presence of sticky services inflation that we have been citing for some time is persisting. Readings in the Atlanta Fed series appear to be topping out but clearly have not come down with CPI (Exhibit 14). Likewise, year-ahead expectations (both Federal Reserve Bank of New York and University of Michigan surveys), another key watchpoint for the Fed, have not de-anchored but are still well above 2% (Exhibit 16).

Exhibit 14: Headline CPI & sticky inflation
Inflation has peaked but remains sticky



Source: BofA Global Research, Atlanta Fed, Bloomberg

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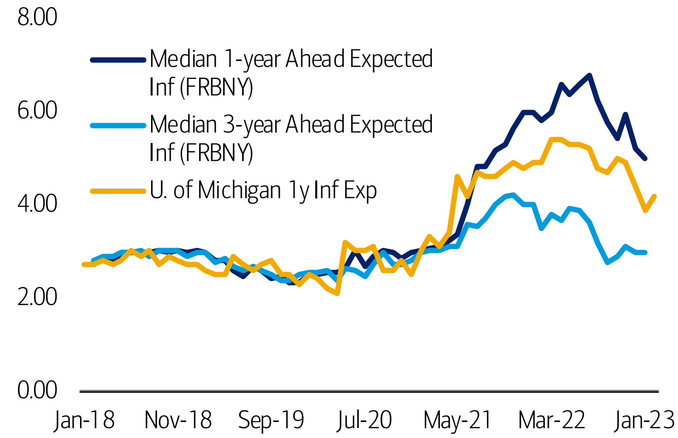
Exhibit 15: Inflation expectations
inflation expectations are not unanchored but still above 2%



Source: BofA Global Research, FRBNY, Bloomberg

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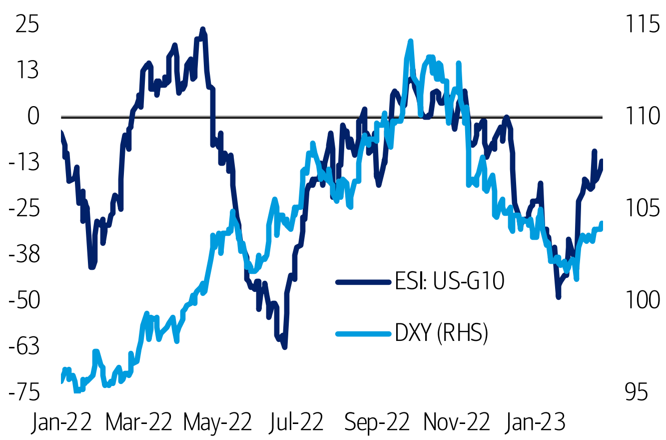
Has been dollar supportive

As for the dollar, its recent (albeit nascent) appreciation could be viewed through the "no landing" lens, with equities and credit losing momentum but not collapsing, as higher terminal and less short-end curve inversion (see the report, Liquid Insight: US rates and re-acceleration risk 22 February 2023) support the dollar.

Indeed, as US data surprises have both materialized and surpassed those of other G10 economies, interest rates have adjusted accordingly, with the DXY-weighted 1y1y overnight index swap (OIS) rate differentials rising back to levels last observed in December 2022 (Exhibit 16, Exhibit 17). This suggests some two-way risk for the USD in this scenario, partly as "data dependence" can impact markets in either direction, partly as "no landing" can keep some investors in a "risk-on" mentality.

Exhibit 16: Economic surprises & the DXY
Dollar supported by recent US growth outperformance



Source: BofA Global Research, Bloomberg

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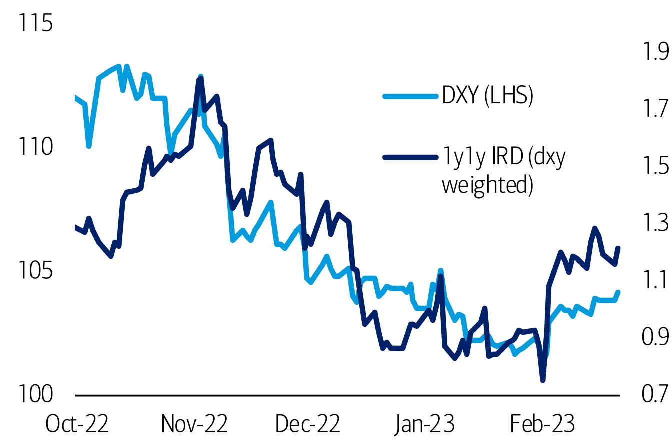
Exhibit 17: Interest rate differentials & the DXY
Dollar rising with rate differentials



Source: BofA Global Research, Bloomberg

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Risks to the "no landing" scenario are inherent, as either a soft or hard landing should ultimately materialize. BofA Global Research's economists expect a recession starting sometime in mid-2023. And while our Fed terminal rate call has recently been upwardly revised by 25 basis points to a target range 5.50-5.75%, we are not calling for cuts until March 2024 (see the report, Federal Reserve Watch: February FOMC minutes: The bar for 50bp remains high 22 February 2023). BofA Global Research's Global Investment Strategy team sees the "no landing" scenario playing out through H1, before giving way to "hard landing" in H2 (see the report, The Flow Show: Next stop 3.8k 16 February 2023).

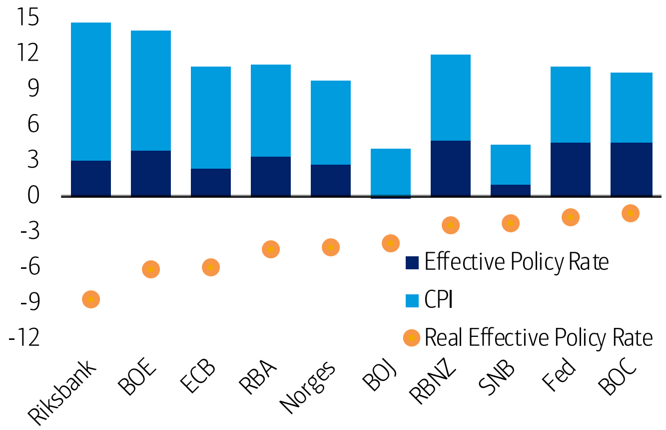
Looking ahead

Real rate support should continue

Contemplating the potential scenarios above and how global policymakers might react suggest a potentially narrowing path towards dollar depreciation and hence upside risks. As we have been arguing, currencies should do well where monetary policy is seen as committed to staying the course on inflation fighting (see the report, Global FX Weekly: Waiting for landing 17 February 2023). If current and projected policy stances are any indication, we can make some inferences about where the market sees vulnerabilities. In this regard, Fed credibility does not appear to be in question at present. Withing the G-10, Fed policy is among the tightest relative to current inflation readings (Exhibit 18). Consensus projections for both monetary policy and inflation imply expectations for the US and Canada to be the only economies with positive real policy rates in 2023 and 2024 and the Fed to be the highest this year (Exhibit 19).

Shorting the dollar (versus G-10) is a negative carry proposition and risks exposure to risk-off moves. Also, it would be likely be associated with an investment thesis predicated on other central banks (CBs) bringing real policy rates notably closer in line with the Fed, amid challenging economic conditions. Absent clear signs on which landing we will get, the choppiness that we have seen thus far in the currency markets is likely to continue, and upside dollar risks should persist.

Exhibit 18: G10 real effective policy rates
Real fed funds among tightest in G10; still negative



Source: BofA Global Research, Bloomberg

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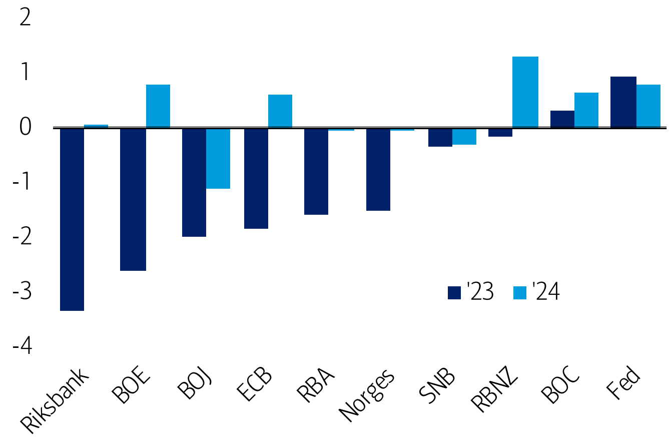
Exhibit 19: 2023 & 2024 real policy rate forecasts
Forecasts imply positive real Fed Funds in 2023 & 2024



Source: BofA Global Research, Bloomberg

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