

Liquid Insight

Shutdown concerns in G10 FX

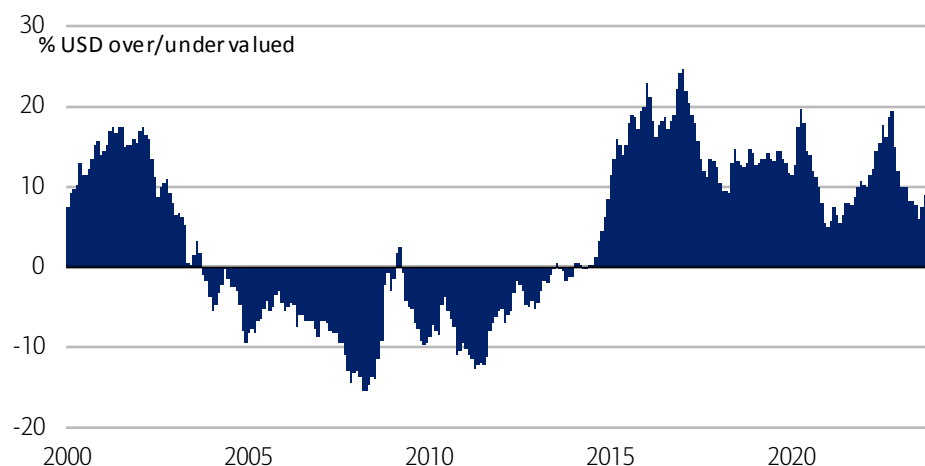
Key takeaways

- We keep our core G10 FX outlook unchanged, including our forecasts for EUR-USD of 1.05 for end-2023 and 1.15 for end-2024.
- In general, we expect inflation to remain inertial and sticky, while robust US growth has helped sustain recent USD upside.
- We revise our USD-JPY views, with an end-23 forecast of 153, while we watch risks such as higher oil and government shutdown.

By John Shin, Athanasios Vamvakidis and Alex Cohen

Chart of the day: USD has become increasingly richly valued

USD roughly 10% stronger than average over previous decade



Source: BIS; BofA Global Research

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Near-term continued USD strength

USD has continued to stay on the stronger side (see [FX Viewpoint: "USD Outlook: The Path to Appreciation Widens", 27 Sep 2023](#)). We continue to look for near-term USD upside, as we keep our end-year EUR-USD forecast of 1.05 (see our [World at a Glance, "Shutdown Anxiety", 25 Sep 2023](#)). The likelihood of relatively more restrictive policy out of the Federal Reserve has continued to be a dollar supportive factor, with US yields creeping higher. Still, we also look for medium-term USD downside, as we still see the current strength as difficult to maintain, with USD roughly 10% stronger than its recent historical trend (see the Chart of the Day). Of course, markets have been anxiously focused on prospects of an imminent US government shutdown.

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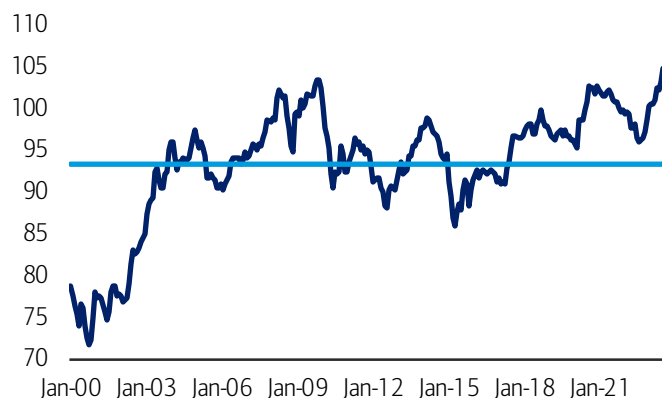
EUR not weak, USD strong

On the European side, weak Eurozone data point to more short-term EUR risks. Although EURUSD has weakened since July, the EUR remains strong vs. most non-USD currencies, with the EUR NEER (Nominal Effective Exchange Rate) at an all-time high (Exhibit 1). Despite weak data, Eurozone inflation remains persistent. The ECB monetary policy is not tight enough to support the EUR and the ECB is now pausing based on its latest assessment – suggesting that only a critical mass of data pointing to more persistent inflation will make them hike again. Eurozone fiscal policy is not tight enough to help the ECB reduce inflation. Eurozone inflation expectations have increased this year.

Real rate differentials would justify a weaker EURUSD. EUR flows have been negative this year, not only for investors and particularly Hedge Funds, but also for officials and corporates. EUR positioning remains modestly long, driven by Real Money, who have only modestly pared back their EURUSD longs this year. Our quant models show bearish EURUSD signals. Technicals are also bearish EUR (for more details, please see [The EUR struggle: outlook for the rest of the year 07 September 2023](#)).

Exhibit 1: EUR NEER

EUR Nominal Effective Exchange Rate at an all-time high

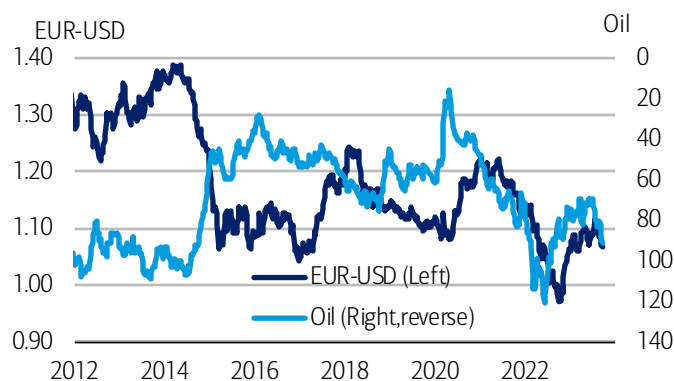


Source: BIS; BofA Global Research

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Exhibit 2: EUR-USD and oil (reversed)

Lower oil was good for USD in years past, but now so is higher oil



Source: Bloomberg; BofA Global Research

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USD: still higher for longer

US economic growth resilience, particularly in relation to the Euro area and China, has been the main driver of the USD over the past several months. During this time, the BBDXY index has moved from the bottom to the top of the year's range, though remains essentially unchanged YTD. While disinflationary signals persist, overall activity data has tended to surprise to the upside. Despite moderation in the employment data, the rebalancing has thus far been gradual and indicative of a still strong labor market.

This plus the growing risk of inflation reacceleration has kept the Fed oriented to a “higher for longer” policy stance. Despite leaving rates unchanged at the September FOMC, economic projections were upgraded, while the fed funds forecasts indicated a shallower than anticipated cut path in 2024 and beyond. Markets price a greater than 50% chance of a final Fed hike by the December FOMC, and debate continues around the prospect that the neutral rate is likely higher than previously perceived.

In contrast, somewhat surprising recent policy holds by the BOE and SNB, and an indication that the ECB may be done with rate hikes has highlighted the growing dichotomy between the US and European economies. Real interest rate differentials between the US and other G10 economies continue to move in favor of the USD.

Forecasts: USD upside, USD-JPY upward revisions

Broadly, we maintain our core view that the USD should be supported into year-end, driven by U.S. growth resilience and the prospect for sticky inflation, which should keep

Fed policy restrictive. Valuation should bring the USD back down towards equilibrium starting in 2024, in our view (see our [World at a Glance, “Shutdown Anxiety”, 25 Sep 2023](#)). We stick to our end-year EURUSD forecast of 1.05, vs. a revised downwards consensus forecast of 1.09 from 1.15 earlier this year. However, we continue to expect EURUSD to start moving towards its long-term equilibrium and historic average next year, with end-2024 at 1.15 and end-2025 at 1.20.

Elsewhere, we revise up our USD-JPY profile, with an end-year forecast of 153 (see Exhibit 3), up from 150 previously. We also look for a peak of 155 in Q1, and a longer-term end-year forecast at end-2024 of 142 (previously 135). However, we keep our Dollar Bloc forecasts the same, with upside against USD for next year. And our Europe FX forecasts also stay unchanged as well. In particular, we keep our EUR-GBP forecast of 0.85 over our forecast horizon.

Risks: the verdict still out on the landing; shaky Q4, led by shutdown anxiety

A lot depends on inflation and the landing scenarios in the Eurozone and the rest of the world. The timing and details of such landing are key risks for the EUR path forward. Our baseline assumes higher unemployment will eventually bring core inflation down next year, but we may see delays on both fronts, unless “something breaks”.

A fresh set of risks have appeared on the landscape, which could work against the USD in Q4, though uncertainty is high. These include growth impacts of the United Auto Workers (UAW) strike, student loan repayments, and the potential for another US government shutdown. The shutdown in particular also adds to the policy complexities by delaying key economic data releases, such as the all-important employment report (see [Morning Market Tibits, “It’s better to stay grounded than fly blind”, 20 Sep 2023](#)).

Higher oil prices could make the Fed’s job more difficult. Our Commodities team revised up their near-term oil price outlook (see [Global Energy Weekly: “The Grind of the Oil Bulls”, 26 September 2023](#)). Recently, though, the inflationary impact has helped USD higher as the Federal Reserve has previously responded to higher energy prices with tighter monetary policy (Exhibit 2).

Additionally, outside the US, China risks increase. As economic pessimism in China is high, the prospect for large fiscal stimulus may be underpriced by the market, which would be USD negative if delivered.

Exhibit 3: G10 FX Forecasts

We keep our forecasts for EUR-USD at 1.05 for end-2023, and 1.15 for end-2024

	Spot	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
G3										
EUR-USD	1.06	1.05	1.07	1.10	1.15	1.15	1.16	1.17	1.18	1.20
USD-JPY	149	153	155	150	146	142	140	138	136	136
EUR-JPY	158	161	166	165	168	163	162	161	160	163
Dollar Bloc										
USD-CAD	1.35	1.32	1.32	1.30	1.28	1.26	1.26	1.26	1.26	1.26
AUD-USD	0.64	0.64	0.66	0.68	0.71	0.71	0.71	0.71	0.71	0.71
NZD-USD	0.60	0.59	0.60	0.62	0.64	0.64	0.64	0.64	0.64	0.64
Europe										
EUR-GBP	0.87	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
GBP-USD	1.22	1.24	1.26	1.29	1.35	1.35	1.36	1.38	1.39	1.41
EUR-CHF	0.97	0.98	0.99	0.99	1.00	1.00	1.02	1.02	1.05	1.05
USD-CHF	0.91	0.93	0.93	0.90	0.87	0.87	0.88	0.87	0.89	0.88
EUR-SEK	11.64	11.70	11.40	11.20	11.00	10.70	10.60	10.50	10.30	10.20
USD-SEK	11.01	11.14	10.65	10.18	9.57	9.30	9.14	8.97	8.73	8.50
EUR-NOK	11.42	11.00	10.80	10.70	10.50	10.30	10.20	10.10	10.00	9.90
USD-NOK	10.80	10.48	10.09	9.73	9.13	8.96	8.79	8.63	8.47	8.25

Forecast as of Sep-26-2023. Spot exchange rate as of Sep-26-2023. 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
- [The path of least resistance](#) **Global FX Weekly**, 22 Sep 2023
- [High & tight](#) **Global Rates Weekly**, 22 Sep 2023
- [Three standout flows](#), **Liquid Cross Border Flows**, 18 Sep 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: The path of least resistance 22 September 2023](#)

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