Liquid Insight

Navigating FX by the R-stars

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Rates and Currencies Research
Global

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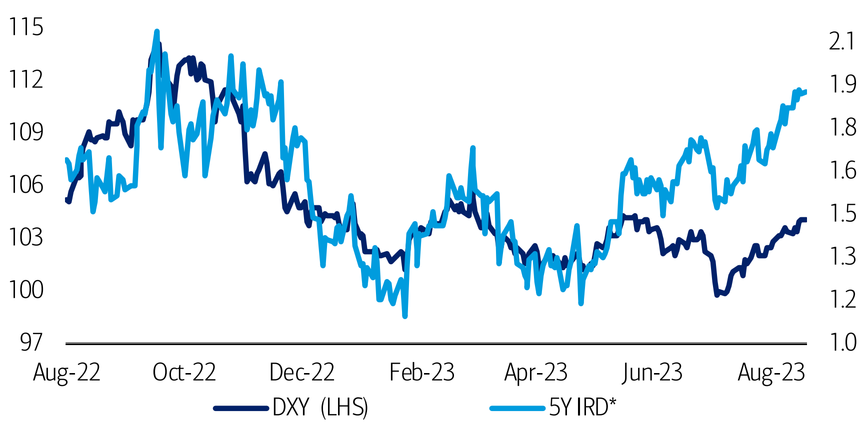
Key takeaways

- The USD has rallied notably over recent weeks, occurring amid rising real rate differentials and proxies for the neutral rate
- Despite limited policy guidance at Jackson Hole, we remain focused on these key rate measures to assess the USD going forward
- We view the market pricing of 2024 Fed cuts as excessive relative to the G10, offering scope for possible further USD support

By Alex Cohen

Chart of the Day: DXY & 5Y Sov. real rate differential (US - foreign)
USD appreciation amid real IRD approaching widest level since March



Source: Bloomberg; BfA Global Research. *IRD= ~DXY weights. Ger (7y), UK (5y), Can (5y), Japan (5y)

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Resilient growth = rate support for the USD

With Jackson Hole (JH) now in the rearview mirror (US Watch: Jackson Hole: a Rorschach test 25 August 2023), the USD looks to close out August by posting its biggest 6-week rally since last September, driven by a number of global factors (see: Liquid Insight: Summer strength in G10 FX 28 August 2023)

In a recent note (Liquid Insight: China clouds USD outlook 29 August 2023) we looked at the impact that deterioration in China sentiment has had on the dollar's recent rally. Here we turn back to the US, to look at the dollar's rally in the context of recent US and global rate moves, including widening real rate differentials, the upward move in the perceived "neutral rate" and the pricing of the Fed and other G10 central bank policy curves through next year.

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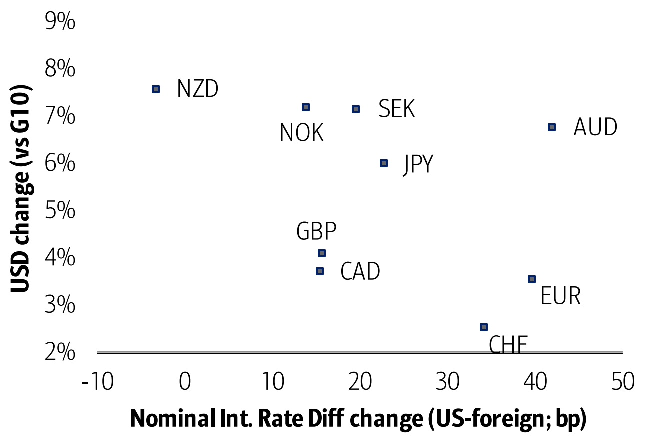
The USD move is "real"

As Chair Powell reiterated in his Jackson Hole speech, US real yields across the curve have been trending notably higher over the past year. Indeed, this rise has advanced even further this month, with the outright 2y real yield at its highest level since 2009, and measures of 5y real differentials (favoring the US) at the widest levels of the year.

"Chart of the Day" looks at the DXY vs. approximate-DXY weighted sovereign real yield differentials. This highlights real yield differentials as a key factor driving the USD higher, while also suggesting the USD might be undershooting the broader move. Indeed, the DXY is now trading towards the top of this year's range (and little changed on yet YTD), while these differentials have reached their widest since November 2022. Bi-laterally, the USD's broad appreciation vis a vis the G10 has generally been proportional to these yield moves, with the potential overshoot versus the NZD (likely due to China related risks) and undershoot vs the EUR (Exhibit 1 and Exhibit 2).

Exhibit 1: USD and IRD changes vs. G10 since mid-July
USD appreciates broadly amid widening IRDs



Source: Bloomberg; BofA Global Research

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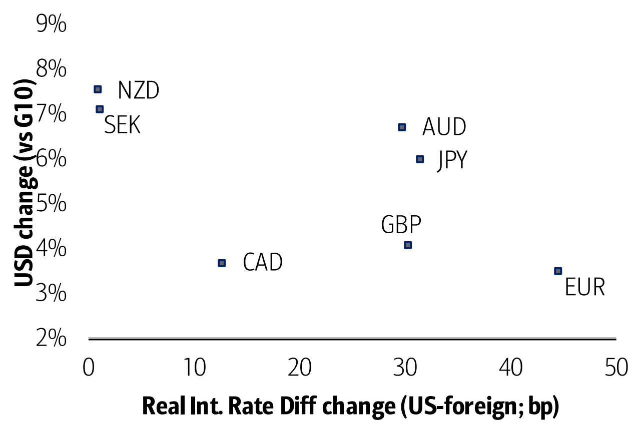
Exhibit 2: USD and real IRD changes vs. G10 since mid-July
USD appreciates broadly amid widening IRDs



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Navigating FX by the R-stars

This rise in real rates amid broader signs of US economic resilience has advanced the Fed outlook debate from a narrower focus on the terminal rate, towards the direction of the eventual neutral rate of interest, ie. "r-star". This debate has been spurred in part by New York Fed's recent blog posts on the subject, and captured the attention of the market and the financial media alike. Exhibit 3 shows the story count for both "neutral rate" and "R star", both of which have jumped materially over the past week.

As our Rates Team has recently highlighted (Liquid Insight: Finding a higher "neutral" ground 10 August 2023), a reasonable proxy for the market's pricing of the neutral rate is the 1 year Overnight Index Swap (OIS) rate, 3-years forward ("3y1y"). However, as is widely noted, the neutral policy rate cannot be observed either ex-ante, or in real time. This fact ultimately clouds the assessment of how restrictive monetary policy is or is priced to be. Chair Powell underscored this uncertainty in his JH speech, potentially to the disappointment of those expecting greater clarity on the Fed's views here.

Regardless, a growing economy with relatively higher real interest rates should be able to withstand a higher neutral policy rate. All else equal, currencies in economies with relatively higher neutral rates should ultimately find support. As has been observed recently, the dollar's recent rally since mid-July has occurred amid a favorable widening in the 3y1y rate differential between the US and most other G10 economies (Exhibit 4).

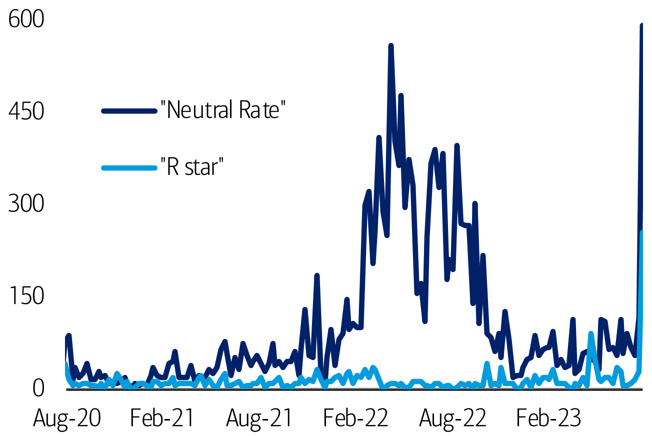
The correlation of changes among these measures is positive, as one would intuitively expect. This correlation has been trending toward the higher end of the post-covid range since the time of liftoff, only to be set back temporarily this year during the regional bank episode from March.

However, as it relates to the USD, the proxied neutral rate level is roughly in the middle of the pack amongst the G10; lower than the typical higher-yielding AUD and NZD, as well as the GBP which is currently experiencing structurally higher inflation and a related higher interest rate complex. This rate is modestly higher than that of CAD and other European currencies, while notably higher, as one would expect, than the typically low yielding CHF and JPY.

Putting this together, the 3y1y nominal US rate pricing reflects expectations for the Fed to cut policy rates the most among the G10 (along with the BOC). However, this gap could widen or narrow in accordance with continued resilience, or lack thereof, in the incoming US data.

Exhibit 3: Bloomberg Story Counts featuring "Neutral Rate" or "R star"

Financial media coverage of neutral rates jumped notably this week



Source: Bloomberg; BofA Global Research

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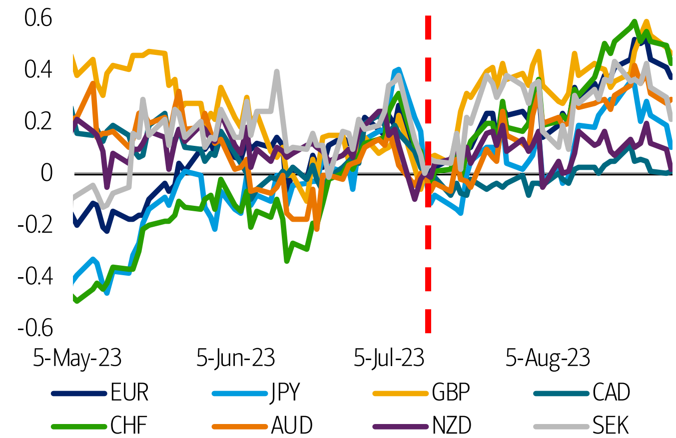
Exhibit 4: Change in 3y1y differentials (US-Foreign); indexed to recent trough in DXY (14 July)

USD rally occurred amid favorable widening in neutral rate proxy differentials



Source: Bloomberg; BofA Global Research

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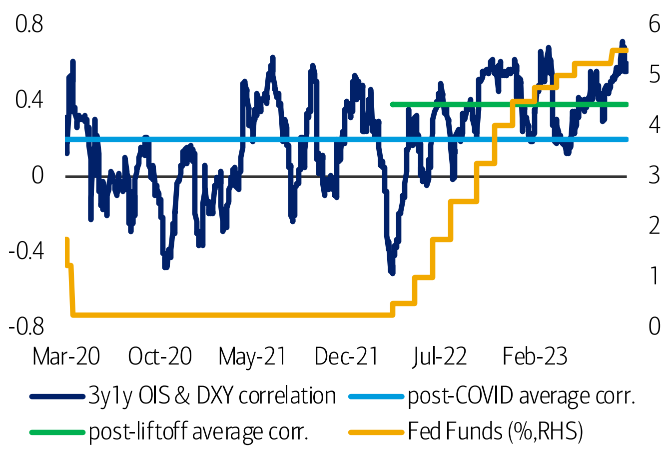
Exhibit 5: Correlation of daily changes: DXY & 3Y1Y OIS (30d)

USD & 3y1y correlation near post-Covid highs



Source: Bloomberg; BofA Global Research

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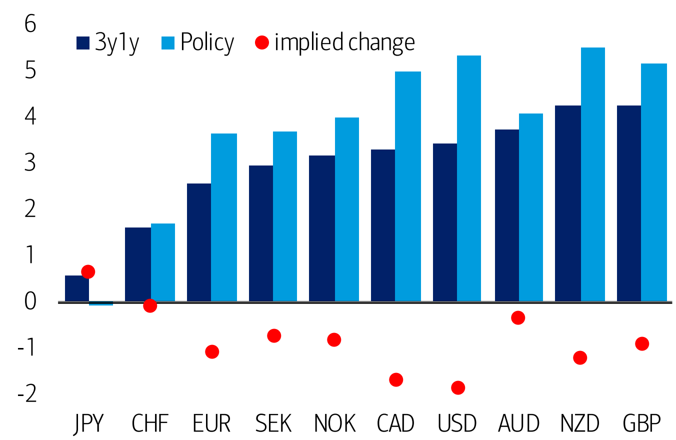
Exhibit 6: G10 Policy Rates, 3y1y rates, and implied change

US priced to have the biggest decline from policy to neutral rate



Source: Bloomberg; BofA Global Research

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Fed pricing still looks excessive

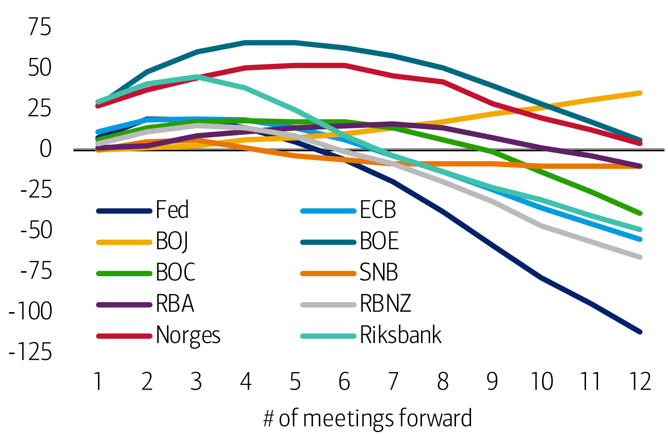
Prior to the ex-post realization of where the neutral rate will land, markets will continue to focus on the path of central banks. With global policy rates mostly at or near terminal, the trajectory of expected cuts is and will continue to be a key factor for the FX market. As it relates to the USD, should the Fed ultimately assess the approximate neutral rate to be somewhat higher than previously thought, then the expected path down in rates would likely be shallower than markets are currently priced.

Despite recent US economic outperformance, market pricing still has the Fed cutting rates faster and deeper than its G10 counterparts though 2024. Exhibit 7 shows the next 12 meetings of G10 central bank pricing. Clearly the Fed's cutting path stands out amongst its peers, with approximately 95bp of total cuts through the December 2024 (the 11th meeting from now). This partial divergence is still quite notable, even despite the pricing out of around 50bp of these cuts since mid-July.

However, looking solely at these cuts in a vacuum only tells a portion of the story, as each country is in a different place in the inflation cycle. To see this in a different context, Exhibit 8 plots cumulative pricing of cuts through 2024 against the expected change in inflation during this time. This inflation gauge is derived from the consensus headline CPI for year end 2024 – the most recent reading in each country. While this expected inflation measure is imprecise and subject to differences in calculation/time horizons, it gives a rough display of the generally expected trajectory in each country.

In theory, the degree to which current CPI exceeds forecasted CPI should be somewhat proportionate to market pricing of cuts priced for central banks of those countries, all else equal. This mainly holds true for most countries, with the US/Fed being the notable outlier.

Exhibit 7: G10 central bank pricing (cumulative bp)
Pricing of Fed cuts still fastest/deepest among G10



Source: Bloomberg; BofA Global Research

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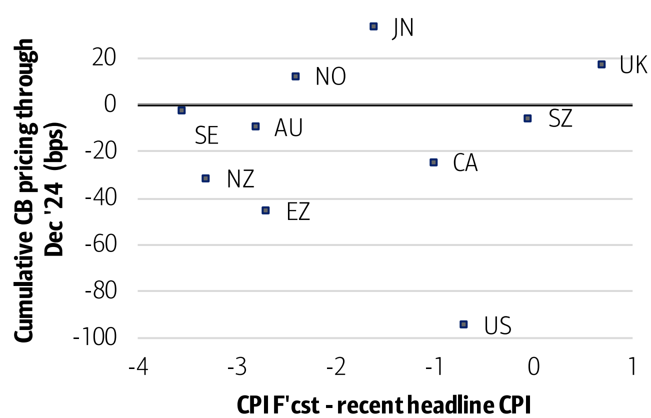
Exhibit 8: Cumulative policy cuts through 2024 & projected change in inflation rates
Except for the US, inflation outlooks generally correspond with pricing of cuts



Source: Bloomberg; BofA Global Research

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As we have argued this year ([FX Viewpoint: G10 FX for rest of 2023: all about the landing 03 August 2023]), the pricing of Fed cuts appears excessive and inconsistent with both the Fed's guidance and our Econ team's rate forecasts. One message from JH is that while the Fed will proceed carefully at this stage in the tightening cycle, they are far from declaring victory over inflation, and prepared to do what is necessary to return sustainably to 2% inflation. Barring a major economic or market shock, the magnitude of these cuts should continue to gradually price out as inflation reacceleration risks will likely continue. And should data remain broadly resilient, perceptions of a potentially higher neutral rate will persist, serving as a factor generally supportive of the USD in the near-term.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- High rates until 2% at the end of the tunnel **Global FX Weekly**, 18 Aug 2023
- R*s be our guide **Global Rates Weekly**, 11 Aug 2023
- Support for USD vs. GBP, CHF, CAD; EM interventions, **Liquid Cross Border Flows**, 21 Aug 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: High rates until 2% at the end of the tunnel 18 August 2023

Global Rates Weekly: R*s be our guide 11 August 2023

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