FX Watch

USD: Still rangebound, but potential catalysts loom

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G10 FX Strategy
Global

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Key takeaways

- The USD has been remarkably rangebound over recent weeks, as the market awaits a fresh catalyst after the YTD rally from Jan
- USD momentum loss due to: US-global data convergence, potentially noisy Jan inf data & mkt Fed pricing now matching the SEP
- Potential catalysts this week: Powell, ECB, and most significantly Friday's NFP could serve to break the USDs recent range

Holding pattern

G10 FX, and the USD specifically, has been remarkably stable over the past several weeks. After a notable selloff at the end of last year, and a surprise rally YTD, the dollar has run out of steam, and in search of a fresh catalyst. Put into perspective, the 1-month moving average of the DXY's daily range has reached its narrowest level in over two years, registering in the 10th percentile of readings over the past 10 years.

SEP = Summary of Economic Projections

ECB = European Central Bank

DXY = Dollar Index

ISM = Institute for Supply Management

Why has the dollar stalled?

We see several reasons why the dollar has failed to continue its upward momentum from earlier in the year. US data outperformance has stood out on a relative basis to start the year, but some recent downside surprises has been viewed in the context of some more optimistic signs globally. And while January inflation data in the US notably printed to the upside, questions remain about the possibility for weather and seasonality distortions. And with market pricing of the Fed now essentially in line with the SEP forecasts, there is limited scope for further repricing, absent a new wave of even stronger US data and/or more assertively hawkish signals from the Fed. Finally, China sentiment appears to have bottomed, spurred on by incremental easing measures by the authorities.

Could this be the week?

While expectations should be managed, there are a number of key events later this week that could shake up the market. Fed Chair Powell gives his semi-annual testimony to Congress on Tuesday and Wednesday. While scope for guidance beyond his most recent remarks From January, the market is likely to glean some insight into their perceived balance of risks and inflation outlook in light of recent data. And while we also have limited expectations for significant policy developments at Thursday's ECB meeting, the FX market will be focused on any signs that the ECB could be looking to cut ahead of the Fed. Finally, Friday's US employment has the potential to create fireworks, as an upside print would further reinforce the signals from the upside January report, while a notable miss would serve to partially validate concerns over January data distortions. Could this be the catalyst that breaks the range?

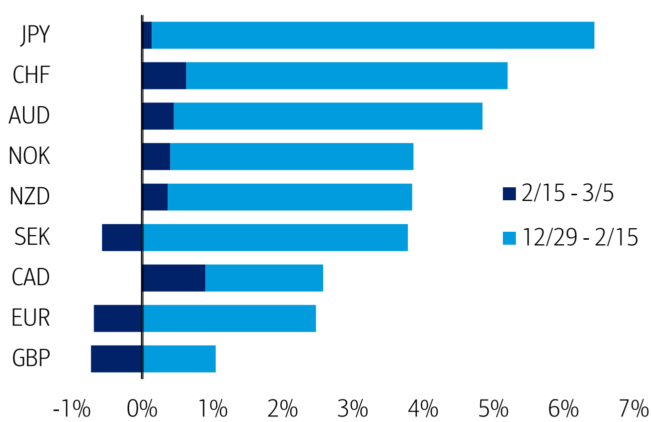
USD in a Holding Pattern

The FX market is in holding pattern, after a full round trip from mid-December to early-February. While the year started off with a fresh bout of USD buying on back of upside US data and more balanced Fed policy guidance, these impulses have run out of steam as the market seeks a fresh catalyst. (Exhibit 1)

Volatility has been notably low, both in implied and realized terms, and the DXY has been within a tight range for the past 3 weeks. Indeed, the 1-month rolling average of the DXY daily range has narrowed to just 0.4%, the lowest reading since late 2021, and registering just the 10th pentile of such readings over the past decade. (Exhibit 2)

Exhibit 1: USD YTD Performance: Dec23 to mid-Feb & mid-Feb to today

USD has outperformed all G10 to start the year, though mostly unchanged over recent weeks



Source: Bloomberg; BofA Global Research

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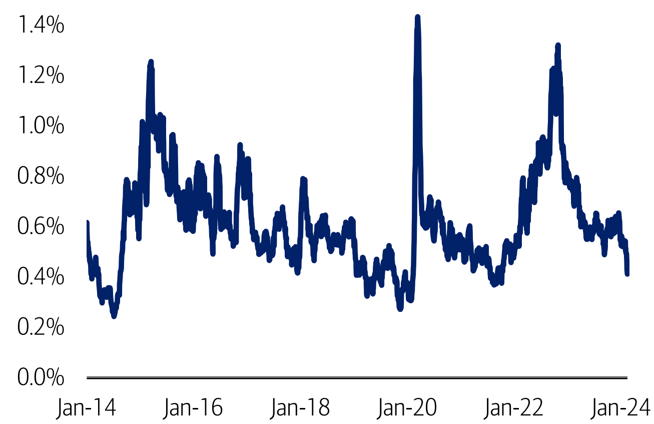
Exhibit 2: 1-Month rolling average of daily % DXY range

February DXY range narrowest since late-2021



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Why has the Q1 ascent stalled out?

As we covered in depth in FX Viewpoint: USD: Bulls versus Bears 29 February 2024, opposing USD camps have formed, with limited incremental catalysts of late to swing the tide in either direction. We see the USD's recent flatlining as likely do to a combination of the following:

1. Relative economic data: While US data relative outperformance remains the prevailing overall FX market theme, the magnitude has waned a bit. Economic surprise indices in the US have lost steam in recent weeks, due in part to recent misses in both ISM manufacturing and services readings for February, while emerging trends in global data have improved. (Exhibit 3) As we noted in FX Watch: FX Seasonality – The Ides of March? 04 March 2024, the hurdle for US data to continue beating expectations should rise over time.

2. US inflation uncertainty: While recent upside inflation readings in the US have garnering notable attention, some caution is warranted. January inflation data may have been elevated due to seasonality and other distortions, which some argue could be offset in coming readings. (US Watch: January CPI Inflation: detour from disinflation 13 February 2024)

3. Fed pricing: Fed pricing has come a long way YTD. As we and others have commented on for some time, the number of Fed cuts priced into the market were well over done coming into the year. At long last, this pricing has recently adjusted to a more reasonable level, with the market roughly in line with the Fed's SEP projections of ~3 cuts this year. (Exhibit 4) With that adjustment having taken place, it is also reasonable for now that the market does not go too far beyond this, absent

a new wave of even stronger US data and/or more assertively hawkish signals from the Fed. This has seemingly capped USD upside for the time being.

4. China: As we noted in Liquid Insight: USD - Caveat Emptor 28 February 2024, incremental easing in China and signs of a bottoming in China sentiment has served as a USD headwind recently.

Exhibit 3: US and Global Economic Surprise Indices

Gap between US-Global data surprises has narrowed over the past month

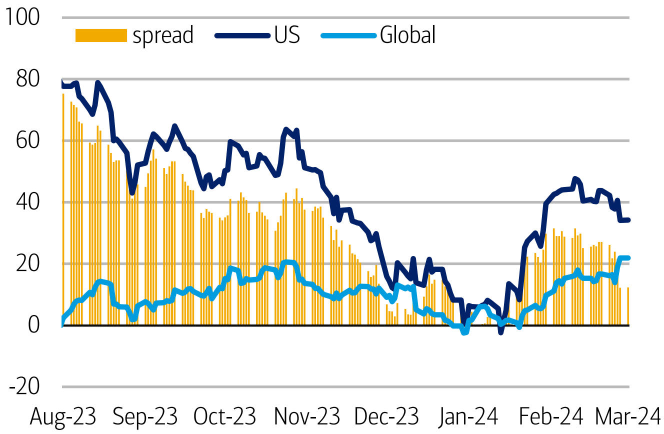

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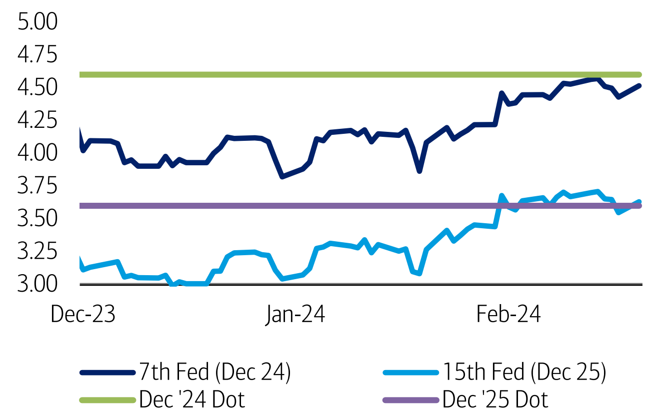
Exhibit 4: OIS pricing for December '24 & '25 meetings and Fed Projections

Market pricing has recently converged up to the Fed's forecasts



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Could this be the week?

There's a lot on the event calendar for later this week that could awaken the market, though devil will be in the details.

Powell's Testimony:

On Wednesday (House) and Thursday (Senate), Chair Powell will give his semi-annual testimony to Congress. Among other things, the market will closely watch the prepared remarks and Q&A for a fresh reading on the Fed's inflation outlook and any hint of how they are viewing the policy outlook. That said, it seems unlikely Powell will stray too far from his previous remarks, and the likelihood of a fresh policy signal is remote. (Morning Market Tidbits: Powell to Congress: Inflation has slowed without higher unemployment 05 March 2024)

Powell and other Fed speakers have been clear that they see March as too soon to cut, and at the January FOMC he also asserted that he is not necessarily looking for better inflation data than has been received, but rather more months' worth of confidence inspiring readings. While not specifically a calendar-based guidance, this did introduce an element of time into their reaction function. More recently, other Fed officials have echoed this sentiment, with Governor Waller noting in his February 22nd speech: "*I am going to need to see a couple more months of inflation data to be sure that January was a fluke and that we are still on track to price stability.*" Given recent upside prints, this seems broadly consistent with market pricing of an ~80% change of a June cut. While expectations should be managed, recall Powell has surprised the market at the past 2 Fed meetings.

ECB Meeting

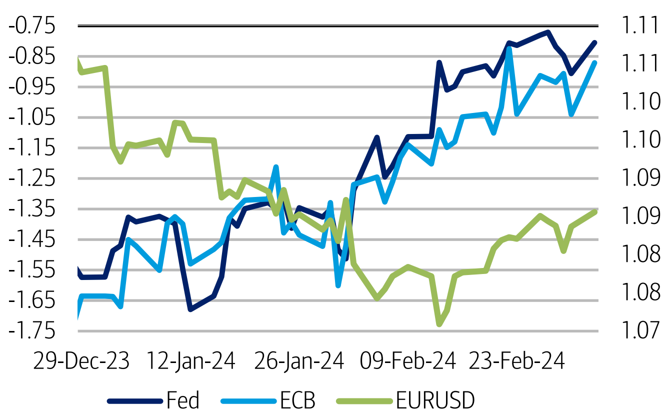
Similarly, we do not expect any major policy surprises at Thursday's ECB meeting, but any hint of when cuts could be coming should be the primary focus. (Liquid Insight: ECB Preview: Not yet, but soon 04 March 2024) For the FX market, and EUR/USD specifically, this will be viewed in the context of how guidance (if any) compares to that of the Fed. Our economists continue to call for both to cut first cut in June and for a quarterly pace in 2024. Market pricing this year has shown cuts being pared back for both central banks rather similarly, with EUR/USD trading independent of this trend. (Exhibit 5)

February Employment Report

The February employment report on Friday will be the grand finale of an eventful week. Recall, the last sustained leg higher in the USD this year came on back of the blowout January employment report which showed, among other things, 353k nonfarm payroll adds against expectations for 185k, and a steady 3.7% unemployment rate. This saw the DXY rise over 1%, the biggest upside reaction of any employment report since the Fed has been on hold. (Exhibit 6) Notable 2-way risk exists going into Friday's report. On one hand, another upside print would serve to confirm the signal from January, and breath further oxygen into the narrative that the Fed may need to delay cuts even beyond June. On the other, a soft report, would reinforce the most recent trend of softening data and serve to bolster the case that January data distortions resulted in more noise than signal. We will soon find out if this could be the catalyst that breaks the USD's range.

Exhibit 5: Fed & ECB Cuts (ppt) priced through Dec 24 & EUR/USD

Pricing out of Fed and ECB cuts for '24 have occurred at a similar pace this year, with no clear direct impact on EURUSD



Source: Bloomberg; BofA Global Research

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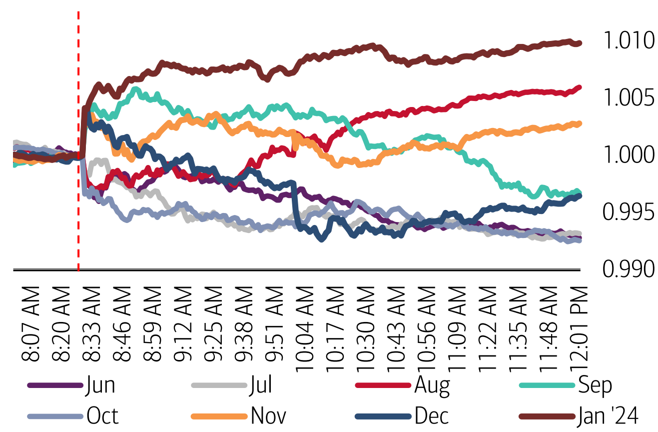
Exhibit 6: Intraday DXY move on past eight employment report days (index to 1 at 8:29 AM)

Jan '24 report elicited the biggest USD upside reaction since the Fed has been on pause



Source: Bloomberg; BofA Global Research; *Date refers to report month, not release month

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