

Liquid Insight

USD - Caveat Emptor

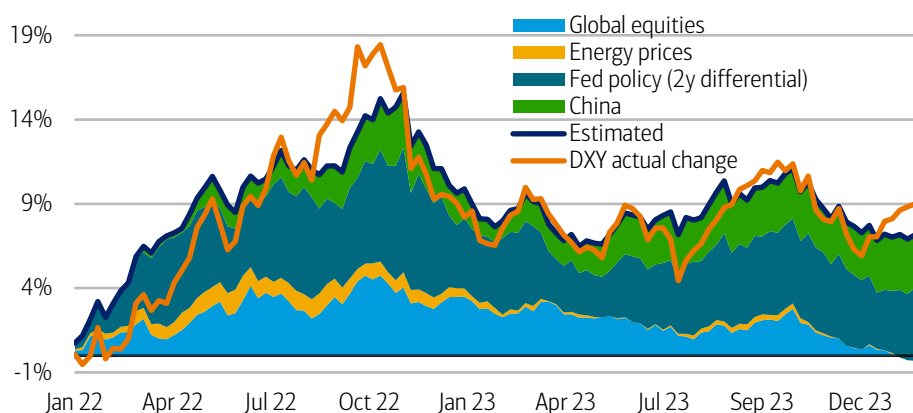
Key takeaways

- DXY overshoot to fundamentals more meaningful compared to January; caution on USD longs especially vs. JPY.
- Divergence approaching Oct 22 and Jul 23 levels, which were associated with higher volatility than current implied levels.
- Tech stocks less important for G10 FX than broader equities; PBoC reaction function can amplify effect of Fed easing on USD.

By Adarsh Sinha

Exhibit 1: DXY dollar index: 2022-to-date, actual vs. estimated

Divergence approaching Oct 22 and Jul 23 levels



Source: Bloomberg. Note: global equities = MSCI World, energy prices = BCOMEN Index, Fed policy = DXY weighted 2y rate differential, China = first PC across equity, credit, bonds, FX, iron ore

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Some observations on USD overshoot

In contrast to January, the DXY dollar index has diverged more meaningfully from its key drivers. Fed repricing has supported the dollar but offset by robust equities and some improvement in China sentiment. While carry is supportive, we caution against buying USD at current levels, especially vs. JPY, where there is risk of policy resistance. This divergence also implies upside risk to implied volatility. We show that while broader risk sentiment matters for G10 FX, the relative performance of technology stocks is less important. A strong negative correlation between US rates and China sentiment is symptomatic of the PBoC's reaction function, which in turn can amplify the impact of eventual Fed easing on USD.

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Timestamp: 27 February 2024 11:44PM EST

28 February 2024

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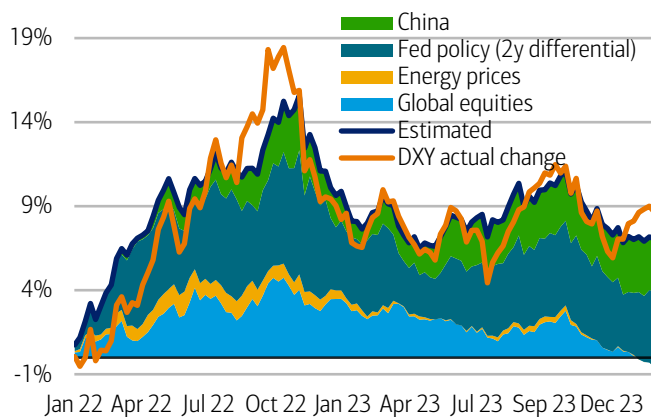
DXY overshoot looks meaningful – caution on USDJPY

In January we argued the USD overshoot (relative to risk sentiment and rate differentials) was less dramatic than it first appeared ([Global FX weekly 26 January 2024](#)). This is no longer the case with our DXY framework showing the gap between actual and estimated levels approaching divergences observed in July 2023 and October 2022 (Exhibit 2).

While there has been meaningful repricing of Fed rate cuts since then, this was offset by robust equity performance and some improvement in China sentiment. This suggests caution against buying USD at current levels especially as the market may struggle to price in fewer cuts ([Liquid Insight 27 February 2024](#)). This is especially relevant for USDJPY: while we are structurally bullish, there is near-term downside risk from potential policy resistance from BoJ and MoF ([USD/JPY may face policy resistance in spring 27 February 2024](#)).

Exhibit 2: DXY dollar index: 2022-to-date, actual vs. estimated

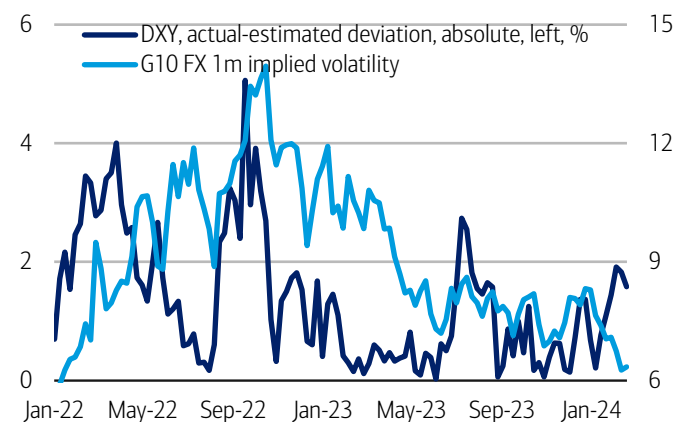
Increasing divergence between actual vs. estimated DX levels...



Source: Bloomberg. Note: global equities = MSCI World, energy prices = BCOMEN Index, Fed policy = DX weighted 2y rate differential, China = first PC across equity, credit, bonds, FX, iron ore
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Exhibit 3: DXY actual-estimated divergence (absolute) vs. 1m vol

... may eventually be associated with higher volatility



Source: Bloomberg

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Overshoot implies higher vol

The overshoot described above also points to some upside risk to implied volatility (Exhibit 3). Low volatility has been the consequence of stable rate differentials due to a roughly uniform back up in rates across major economies. Exhibit 4 shows for instance the realized volatility of DX weighted 5y differentials has fallen to its lowest level since early 2022 (Exhibit 4).

While central banks are striking a similar tone for now (rate cuts not imminent), the dispersion of data surprises has risen, partly driven by contrasting inflation data (Exhibit 5). In our view, a global easing cycle will be associated with higher rate differential/FX volatility ([FX vol looks beyond recent US data 21 February 2024](#)). While volatility curves are steep, the recent flattening offers opportunity to accumulate vol and/or hedge long-term exposure.

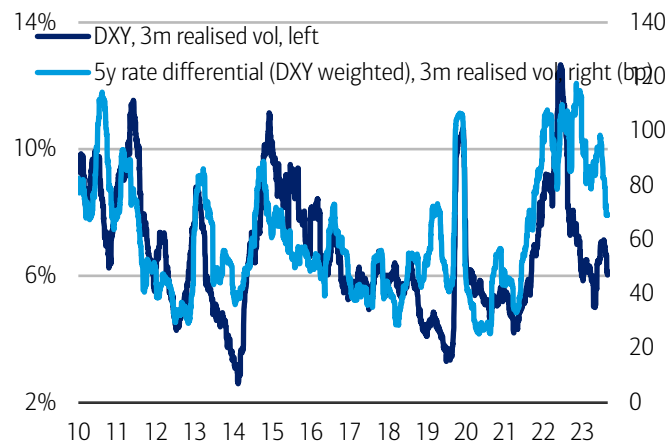
Risk sentiment matters for G10, tech stocks less so

Risk sentiment (proxied by MSCI World) has a statistically significant relationship with DXY within our framework. But the relevance of technology stock performance is less clear – the strong NVIDIA results last week for instance had limited impact on FX. Exhibit 6 suggests the relative performance of tech stocks is less important than overall risk sentiment, with a few exceptions. The one year betas of major currencies (vs. USD) to the relative performance of NASDAQ vs. Dow Jones Industrials are mostly close to zero. KRW and TWD have statistically significant betas, both naturally influenced by technology exports as well as inflows to their tech-dominated stock markets. Within

G10, NZD's high beta to relative tech stock performance is harder to explain but we remain bearish NZD crosses following the less hawkish RBNZ today ([RBNZ review: Dovish turn in sight 28 February 2024](#)).

Exhibit 4: Realised volatility – DXY vs. weighted 5y differentials

Rate differential volatility has collapsed...

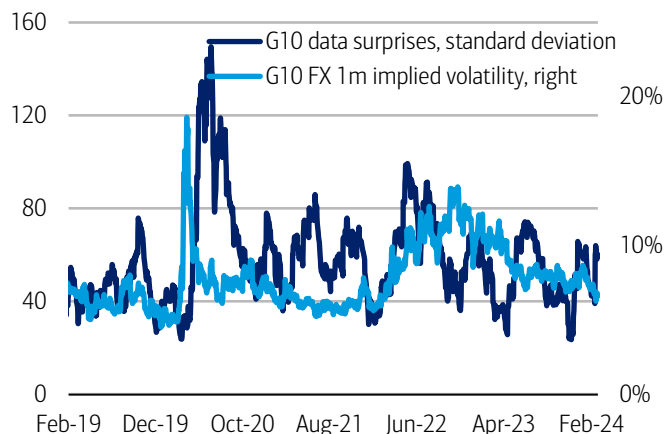


Source: Bloomberg

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Exhibit 5: G10 dispersion of data surprises vs. 1m vol

... but dispersion of data surprises is rising



Source: Bloomberg

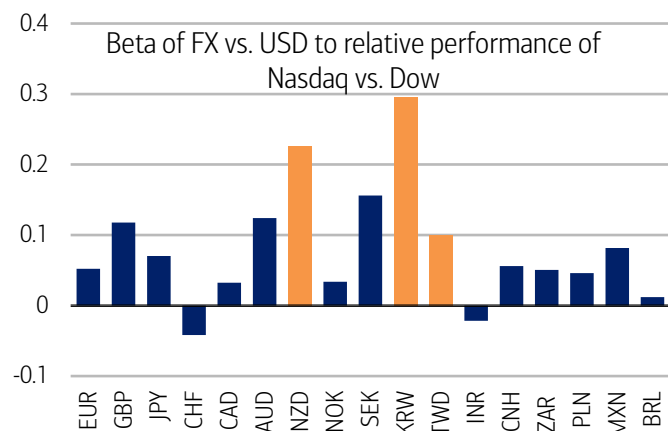
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China can amplify impact of US rates on USD

Signs of bottoming in China sentiment may cap the upside in USD. The larger-than-expected 5yr LPR cut signaled intent to strengthen support for the property sector ([China Watch 20 February 2024](#)). While this is not yet evident in new home sales, the LPR cut should help restore some housing confidence in the near term. The PBoC has acknowledged that Fed rate cuts would provide room for further monetary easing by reducing FX pressure. This can amplify the impact of Fed policy on the USD, through its second-order effect on China policy and sentiment. Exhibit 7 shows this is already evident in the historically strong negative correlation between US rates and China sentiment.

Exhibit 6: Beta of FX (vs. USD) to relative performance of Nasdaq vs. DJIA (one year lookback)

Only KRW, TWD and NZD betas are statistically significant



Source: Bloomberg. Note Betas show % move in FX associated with 1pp outperformance of Nasdaq vs. DJIA. Orange bars denote statistical significance of estimated betas

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Exhibit 7: Correlation of US rate differential with China sentiment

Impact of US rates on USD likely amplified by China channel



Source: Bloomberg

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Notable Rates and FX Research

- **Global Macro Year Ahead 2024** - [Hope for the best, prepare for the worst](#), 19 Nov 2023
- **Global Rates Year Ahead 2024** – [Cloudy with a chance of landing](#), 19 Nov 2023
- **G10 FX Year Ahead** - [The year of the landing](#), 20 Nov 2023
- [Dollar dependence](#), **Liquid Cross Border Flows**, 19 Feb 2024

Rates, FX & EM trades for 2024

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[Global FX weekly: Silver linings playbook 23 February 2024](#)

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