FX Watch

USD consolidates amid cautious Fed-speak

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G10 FX Strategy
Global

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Key takeaways

- The USD has started Q3 in consolidation mode after reaching YTD highs on relative U.S. growth outperformance.
- Fed has expressed caution over recent financial conditions tightening, suggesting possibly less need for further hikes.
- Meanwhile, economic data remains resilient, resulting in notable swings in front-end rates pricing and USD cross-currents.

USD consolidates after reaching YTD highs

The USD has broadly consolidated over the past 1.5 weeks, after reaching fresh year-to-date highs in early October. Interestingly, and perhaps counter-intuitively, this has occurred amid US economic data still reflecting growth resilience and rising geopolitical tensions. Since reaching its year-to-date peak on October 3, the DXY has depreciated by about 1%, amid bi-lateral deprecation (excluding JPY), versus both higher- and lower-beta currencies.

Fed commentary highlights tightening financial conditions

Fed commentary during this time has been a key catalyst to the consolidation, as members have expressed a more balanced risk assessment at this point in the hiking cycle, amid the ongoing rise in rates. This, along with today's CPI, has resulted in notable swings in market pricing of the Fed's policy curve, as investors assess prospects for both the "higher" and "longer" aspects of the Fed's stance.

Refer to important disclosures on page 5 to 6.
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USD consolidates around YTD highs

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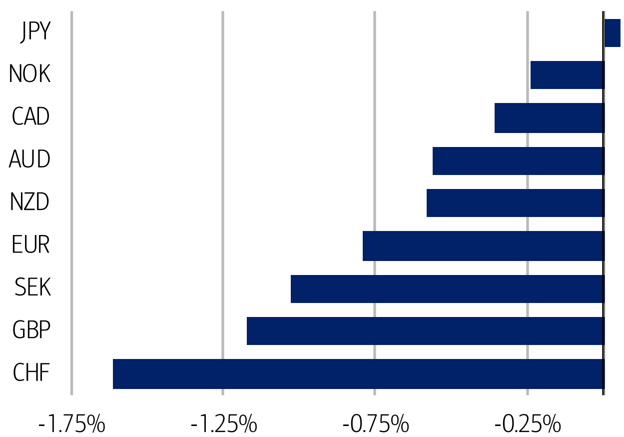
Exhibit 1: Change in USD versus G10 since October 3rd peak
Dollar has depreciated broadly versus most G10 currencies



Source: Bloomberg; BofA Global Research

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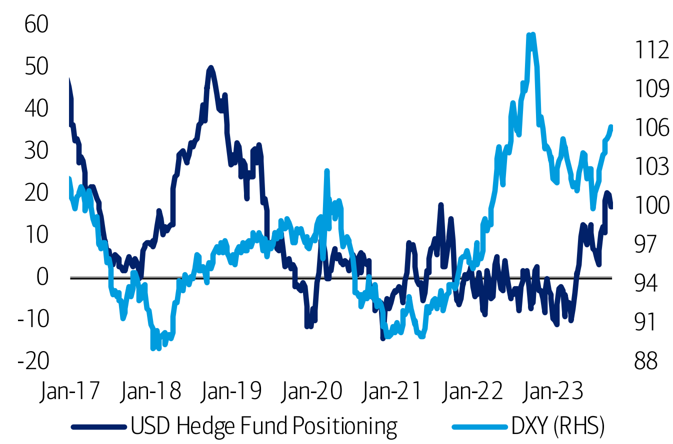
Exhibit 2: USD hedge fund positioning and the DXY
Hedge funds net-long USD positions around highest level since mid-2019



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Fed commentary underscores tightening financial conditions...

Prior to this recent consolidation, the recent rise in US Treasury yields has been significant, driven in part by strong U.S. growth data, Fed projections for a "higher for longer" policy stance, and supply/demand imbalances in the treasury market (see the report, Liquid Insight: US rate shock FAQ 11 October 2023). This has lifted the USD and broadly weighed on risk appetite over this time, resulting in a notable rise in term premium and tightening in financial conditions (Exhibit 3; Exhibit 4).

Exhibit 3: US financial assets performance since USD's YTD trough (7/14); Indexed to 1

USD rally amid tightening financial conditions

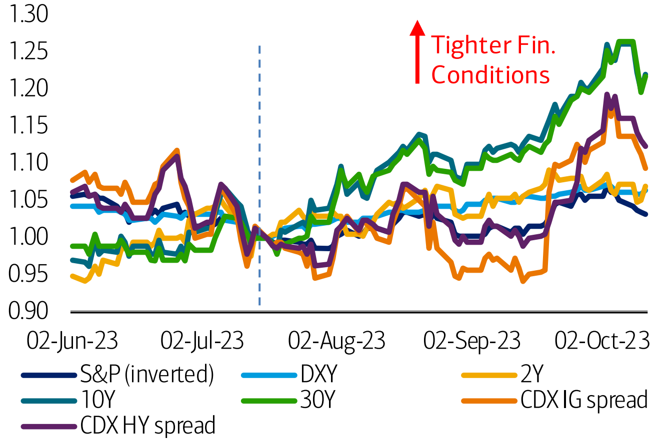

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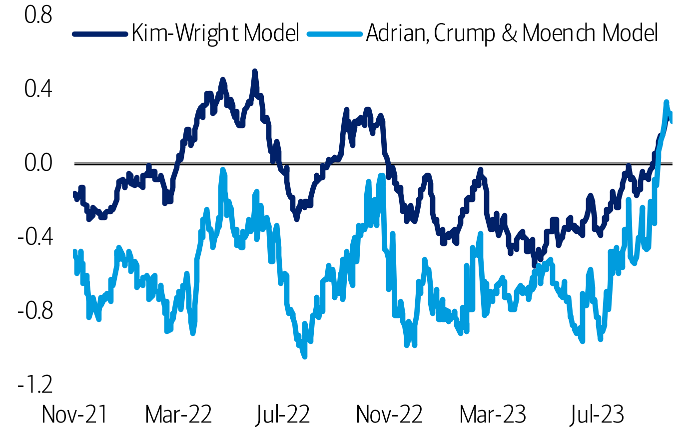
Exhibit 4: 10-year US Treasury term premium estimates

Longer-dated term premium has recently and rapidly turned positive



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This has clearly captured the attention of FOMC members, several of which referred to this tightening in recent speeches. Most notably, we note the following:

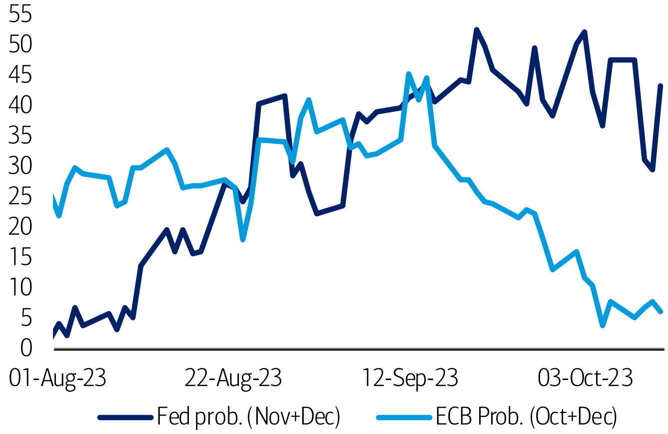
- San Francisco Fed President Daily: "…if financial conditions, which have tightened considerably in the past 90 days, remain tight, the need for us to take further action is diminished." While also noting that amidst disinflation, "holding rates steady is an active policy action."
- Dallas Fed President Logan: "in setting the stance of monetary policy, the FOMC needs to account for how that stance will translate to the broader financial conditions, including long-term rates as well as credit spreads and other factors, that influence economic activity." And that "if term premiums rise, they could do some of the work of cooling the economy for us, leaving less need for additional monetary policy tightening to achieve the FOMC's objectives."
- FOMC Vice-Chair Jefferson: "Looking ahead, I will remain cognizant of the tightening in financial conditions through higher bond yields and will keep that in mind as I assess the future path of policy."
- Fed Governor Waller: "The Fed can watch and see what happens on rates." And that "financial markets are tightening and that will do some of the work for us."

…leading to a paring back of hiking expectations

As a result, the pricing of additional Fed rate hikes has vacillated notably, as the debate over whether or not this hiking cycle has come to an end has grown louder. Front-end rates markets currently reflect about a 45% probability that the Fed will hike 25bps by the December FOMC meeting (according to the Bloomberg OIS model), though this was as low as about 30% pre-CPI (Exhibit 5). Interestingly, these pricing shifts have not only impacted the expected terminal rate but have also caused swings in the SOFR futures curve out to 2024. Indeed, implied rates on contracts covering 2024 had at one point added back around 20 bps of cuts over the past few weeks, before retracing today. This curve now implies 85 bp of cuts in 2024, to a year-end rate of 4.6%, still notably below the Fed's SEP median projection of 5.1%.

Exhibit 5: OIS pricing of cumulative probability for a further 25bp rate hike in 2024: Fed and ECB

Additional Fed hike getting priced out; ECB expectations negligible



Source: Bloomberg; BofA Global Research

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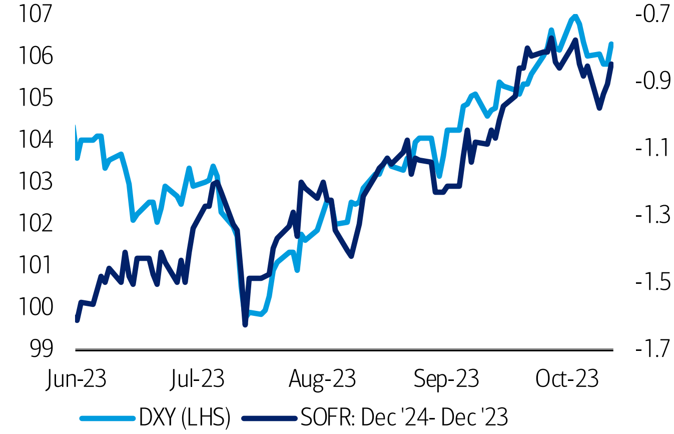
Exhibit 6: DXY & SOFR futures: Dec '24 - Dec '23

Dollar's recent moves tracking with pricing of rate cuts for next year



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US data still resilient

On the data front, last Friday's nonfarm payrolls report resulted in a somewhat puzzling FX and rates reaction. The dollar initially rose along with rates, as the headline number and net revisions beat soundly to the upside. However, these moves more than reversed in the hours after the release, possibly reflecting the relatively narrow sectoral scope of job gains and softening wages (see the report, US Watch: September employment: Late summer surge 06 October 2023).

Today's CPI release served to partly buck the recent consolidation trend (see the report, US Watch: September CPI Inflation: Choppy waters 12 October 2023). While the release offered some mixed signals on the inflation picture, the highly watched core services ex-housing component rose by 0.61%, the highest amount MoM since last September. This has reinforced the view that inflation stickiness is likely to persist, even as prices dis-inflate towards the 2% target.

Uncertainty abounds

Economic and financial market risks are rising. Despite recently expressed Fed cautiousness and market consolidation, financial conditions remain tight. While the Fed is conscious of the building risks of this rapid tightening, a data-dependent approach means that policy will likely continue to be restrictive as growth and inflation remain resilient. Elsewhere, while U.S. and geo-political risks have yet to leave a discernable imprint on the broader market, the situation remains fluid, which could add to the uncertainty over time and in unpredictable ways.

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