Liquid Insight

USD: Upside risks from Fed's Sep SEP; downside risks beyond

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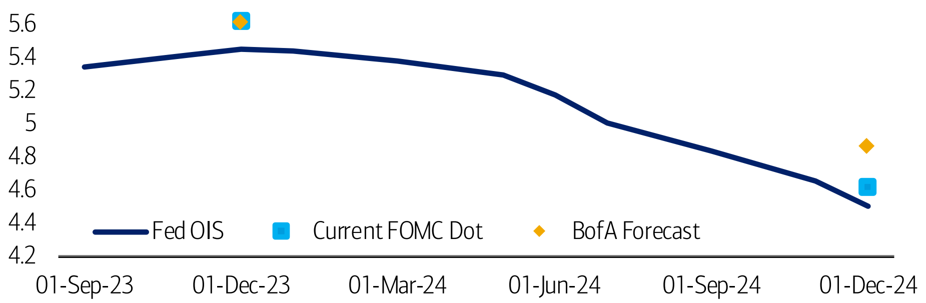
Key takeaways

- Wednesday's Fed SEP dots likely to be maintained (2023) and upgraded (2024+), resulting in a "hawkish hold" interpretation
- If realized, this would pose near-term upside risks to the USD, as markets still underprice the Fed's high-for-long guidance
- Looking past the Fed, USD downside risks include disruptions from the UAW strike, potential govt. shutdown and China stimulus

By Alex Cohen

Chart of the Day: SEP upward revisions could pull US rates higher, supporting the USD

OIS pricing for FOMC dates undershoots Fed SEP and BofA Forecasts



Surce: Bloomberg; BofA Global Research

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Fed's SEP poses potential upside risk to USD…

This week's FOMC is all about the dots. We are calling for upward revisions across the board, which if realized should maintain near-term USD upside on a "hawkish hold" interpretation. Maintaining the final 2023 hike should push market pricing for a final hike above the current 55% probability. Should the 2024 dot be revised up as we expect, the further pricing out of those cuts would likewise be USD supportive. More recently, the BBDXY has undershot the lasts leg of 2024 fed funds futures curve dis-inversion.

…but some USD downside risks loom

Looking beyond this week's Fed, some USD downside risks loom, in our view. While the impact of both the UAW strike and a possible government shutdown should be low, modest downside growth impacts could work against the USD. These are US centric events, and since growth differentials have been a key driver of the USD over the past few months, any disruptions could dampen USD support. Outside the US, market expectations for more significant China stimulus remains low, and pessimism appears well priced into FX markets. These risks could be reasons to tactically fade a Fed induced USD rally.

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SEPtember Dots: Hawkish forecasts to support USD

In a week awash with central bank meetings, the first near-term risk event for the USD is Wednesday's FOMC. (Federal Reserve Watch: Sep FOMC preview: all about the SEP 14 September 2023) With an unchanged rate outcome nearly fully priced in, we look for a "hawkish pause" outcome, which poses modest near-term USD upside risks. We see hawkish potential in 3 main aspects of the SEP dots and related discussions at the press conference.

The final 2023 YE dot:

Recall that the last/only time the Fed kept rates unchanged this cycle was the June FOMC, when the decision was accompanied by an upward revision of the 2023 median dot from 5.125 to 5.625%. (US Watch: June FOMC quick reaction: None, but not done 14 June 2023) The USD appreciated on back of that revision, only to sell off in subsequent days on non-US factors. Thus far the Fed has delivered on its rate guidance, though markets currently assign just a roughly 55% probability that this is realized in full either in November or December, a number that should go up if guidance is maintained. We see it highly unlikely the Fed removes the 2023 hike from the SEP, as it better preserves optionality amidst a resilient economy. To remove it would assuredly result in a "dovish hold" interpretation- a clearly bearish USD signal- but it is unclear what objective that would serve the FOMC. They ultimately could still under deliver on that hike if data flow warrants, but that would make for much cleaner messaging than electing to hike (on upside growth/inflation data) subsequent to a downward dot revision.

USD bottom Line: low probability of very dovish outcome, high probability that Nov+Dec pricing increases. Points to modest USD upside on balance.

The 2024 YE dot:

This is an area posing the biggest potential Fed-induced tailwind for the USD. We expect the median dot to be revised upward from 4.625% to 4.875%, effectively removing one forecasted rate cut. This revision, if realized, would bring the dots more in the direction of our Fed forecasts (see Chart of the Day), and thus our USD forecasts as well. This is an area that we have been highlighting as a potential source of market mispricing, and thus USD upside. Upgrading of this dot would be a fresh reinforcement of the "higher for longer" policy guidance in the face of potential inflation reacceleration risks. Even one of the Fed's most outspoken dovish members, Atlanta Fed President Bostic, has recently suggested that rate cuts are not likely until at least H2 2024. The market, however, has priced below the Fed's 2024 dot curve throughout this cycle, so a status quo 2024 dot could be status quo for the USD. Over the past week, the 2024-2023 fed funds futures curve has dis-inverted from about -100bp to -80bp while the BBDXY index has declined slightly, suggesting this outcome might not fully be priced into the USD. (Exhibit 4)

USD bottom Line: On the extremes, an added 2024 cut would be highly out of step with Fed communication and extremely unlikely, though quite USD negative if delivered. The removal of two cuts seems a more plausible risk in comparison, and would be a low probability, highly USD bullish signal. This points to modest USD upside with 1 removed cut, and more so with 2 removed cuts.

The 2026/ "long run" dots:

This could be a more subtle area for possible USD upside. As we covered in (Liquid Insight: Navigating FX by the R-stars 30 August 2023), US data resilience in the face of higher US rates has shifted the monetary policy debate asymmetrically in the direction of potentially higher eventual neutral rates (r*). Chair Powell was hesitant to cover this in depth at Jackson Hole, but the first release of the 2026 dot and/or any revision to the "long run" dot will be the first opportunity to glean insight on the Fed's thinking on this issue. the prospect of a higher r* is a key reason as to why the USD has appreciated amidst growing "soft landing" expectations (as opposed to it depreciating on better risk appetite). We expect the "longer run" dot to be raised from 2.5% to 2.625% and the initial 2026 dot to come in at 2.9%; both incrementally hawkish signals if realized.

USD bottom Line: While the long-run dot concept is a bit more amorphous than near-term guidance, it does offer a glimpse into the Fed's perception of neutral rates. Upgrades here would reinforce the rise in real interest rates observed in recent months, and also be modestly USD supportive.

Beyond the Fed, USD downside risks await

Looking beyond the September FOMC, other G10 central banks and upcoming economic data, we highlight 3 unrelated areas that could pose various degrees of near-term downside risks to the USD post-FOMC: 1) UAW strike, 2) US Government shutdown, 3) China stimulus.

1) United Auto Workers (UAW) strike: modest USD downside risk

On Friday, the roughly 150,000 UAW workers went on strike, as the union and the "big-three" automakers presumably remain far apart on a wage deal. While it is unclear how long this impasse will persist, some estimate it could go on for several months (Labor Market Watch: UAW Strike FAQ: Strike while inflation is hot 12 September 2023). Any potential impact on the USD would most likely, if at all, be felt over time via the incremental impact on inflation and growth data.

In terms of inflationary impulses, the potential channels are two-fold. First, rising autoworker wages could to some degree be passed through to the price of automobiles, thus impacting inflation statistics on the margin. However, this passthrough could be tempered by the waning demand from pandemic levels. Second, it could serve as a more high-profile example of wage-price dynamics potentially influencing broader approaches to wage negotiations, both union or non-union. This is highly difficult to assess ex-ante, but the longer the dispute goes on, the greater the risks. On the growth side, a prolonged shutdown of the auto industry (and derivative industries) is estimated to result in a 0.1 to 0.2 ppt per week drag on GDP, so the duration of the standoff will matter, with more straightforward implications.

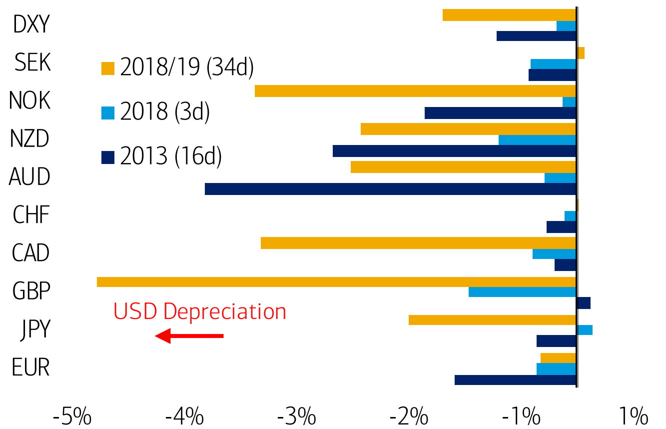
Overall, our economists see this dispute as most likely having a very minor overall impact, but that the downside risks to growth would be more impactful than potential upside inflation risks. From an FX perspective, this points to a downside USD risk, especially if the strike were to drag on longer than expected. US growth (both outright and on a relative basis) has been a key pillar to the USD's recent rise, especially when viewed in contrast with the stagflationary risks in the euro area and UK. A US specific event that resulted in upside inflation and downside growth impulses could push against this contrasting narrative, even if only at the margin.

2) Looming US Government Shutdown

Our base-case view is that a government shutdown will ultimately be avoided, and thus should not have an economic impact (US Watch: Government shutdown FAQ 14 September 2023) However, given the elevated state of contentiousness in Congress, the risk of a shutdown should not be overlooked, as the September 30 fiscal year end date draws near without resolution. Similar with the UAW strike, a shutdown is expected to shave roughly 0.1 ppt of GDP per week, some of which would be recovered upon resolution.

Previous shutdown episodes this century include October 2013 (16 days), January 2018 (3 days), and December 2018/January 2019 (34 days). If history is any guide, the longer-term impact has indeed been limited on broader markets and macroeconomic sense, but some trends in the USD have been observed, albeit over a small sample size. Exhibit 1 shows the USD's bi-lateral moves during each 3 shutdown windows, while Exhibit 2 shows moves in the 30-day window after the date of resolution. In mostly all cases, the USD depreciated broadly during the shutdown window and appreciated post resolution. Given that shutdowns pose an asymmetric albeit modest growth risk, we would anticipate a repeat event to be USD negative at the margin.

Exhibit 1: USD performance during span of past 3 shutdowns
Dollar tends to underperform during shutdowns



Source: Bloomberg; BofA Global Research

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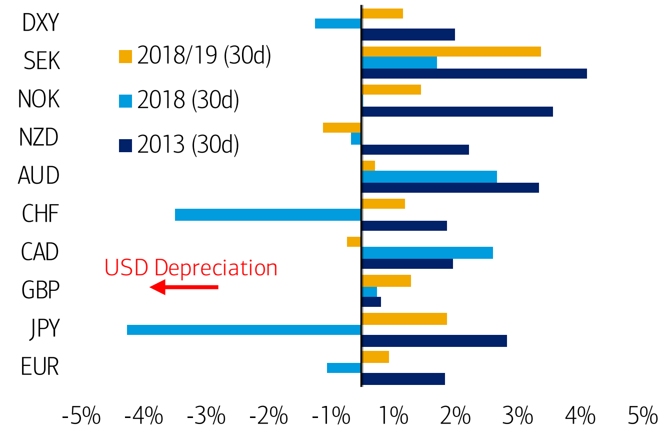
Exhibit 2: USD performance in month following resolution
Dollar tends to recover following shutdown resolution



Source: Bloomberg; BofA Global Research

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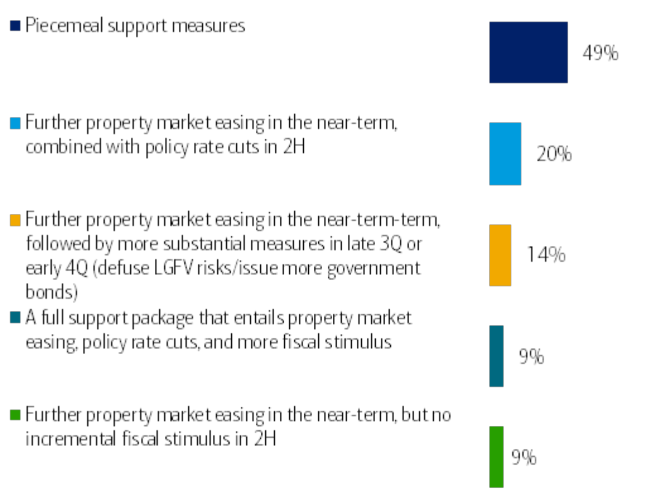
3) China Stimulus

Finally, perhaps the biggest potential risk factor for the USD on the horizon is the prospect for major fiscal stimulus out of China. The lack of major stimulus so far, coupled with the broadly soft economic data has been a key driver of the USD, not only against the yuan and its G10 proxies (AUD, NZD), but against major trading partners such as the EUR as well (Liquid Insight: China clouds USD outlook 29 August 2023).

While a major package is seen by the market as a low probability event (Exhibit 3; FX and Rates Sentiment Survey: Not so neutral 08 September 2023), the potential for further and broader measures remains, and we see some scope for a more active policy maker response over the next few months (China Watch: Some easing is delivered, and more to come 14 September 2023). With the market clearly not positioned for this, it poses the most likely visible risk factor for the USD, particularly vs the aforementioned AUD, NZD and EUR in the G10 space.

Exhibit 3: Survey Question: Expectation for further China policy stimulus?
Piecemeal policy support is modal expectation; full package seen as unlikely



Source: BofA Global Research FX and Rates Sentiment Survey

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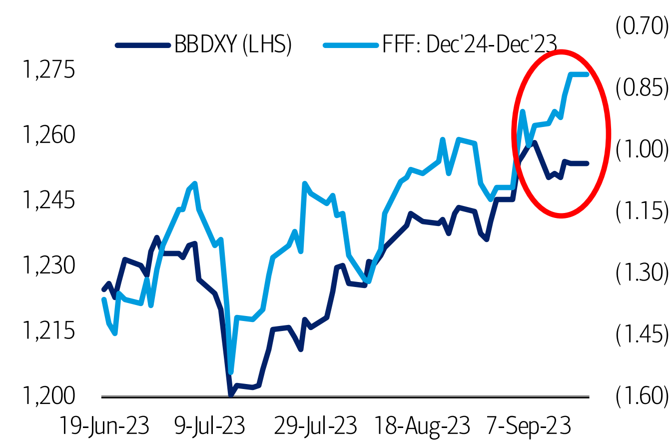
Exhibit 4: BBDXY v. fed funds futures curve: Dec'24 - Dec'23
Fed funds curve has disinverted over past week, while BBDXY has lagged



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- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The art of pausing **Global FX Weekly**, 15 Sep 2023
- Little Dipper **Global Rates Weekly**, 15 Sep 2023
- Ahead of the ECB & US CPI, **Liquid Cross Border Flows**, 11 Sep 2023

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Global FX weekly: The art of pausing 15 September 2023

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