

FX Watch

May flowers for the USD

Key takeaways

- The USD has outperformed over the past few weeks, supported by relative US data outperformance and rising US interest rates.
- US economic data prints in May have shown signs of resiliency, while recent readings in EA and China have missed expectations
- Meanwhile, recent Fed commentary has kept alive discussion about a possible hike at the June FOMC meeting.

Relative data and Fed expectations support the USD

After trading in a relatively tight range for most of April and early May, the USD has broken out to the topside over the past few weeks, appreciating against all G-10 currencies during this time. While broader market attention is highly focused on debt ceiling negotiations, with the X-date rapidly approaching, the dollar's rise has occurred amidst ongoing resilience in US economic data, softer data abroad, and ever-evolving Fed expectations as we approach what may or may not be the terminal rate.

Indeed, US data has continued to evoke a no-landing scenario for the economy for now, while economic data out of Europe has been mixed to slightly softer. Chinese data from April have thrown some cold water on the reopening narrative that fueled some of this year's dollar bearishness.

Meanwhile, commentary from numerous FOMC members has kept alive discussion about possible additional hikes as soon as the June FOMC meeting, where market pricing of a 25bp hike currently stands at around 35%.

25 May 2023

G10 FX Strategy
Global

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Timestamp: 25 May 2023 01:01AM EDT

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While the debt ceiling could have implications for the dollar and broader FX market ([FX Viewpoint: Two-sided FX risk from the debt ceiling 19 May 2023](#)), we see the most recent moves as more fundamentally driven.

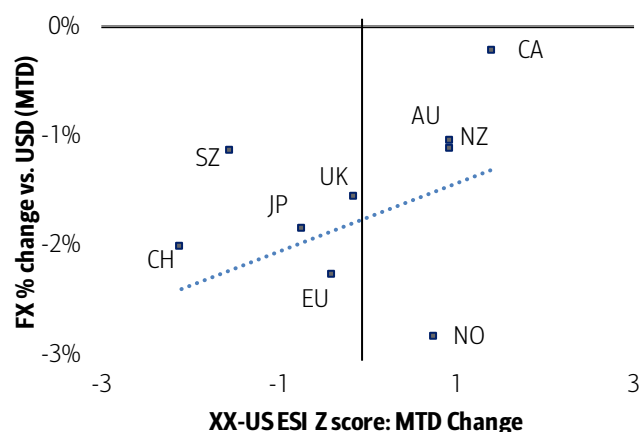
US data has continued to evoke a no-landing scenario for the economy for now. Recent readings of retail sales, claims, services PMI, and U. of Michigan inflation expectations have not pointed to the disinflationary trend that many have been expecting since last year. Moreover, while expected credit tightening on the back of regional bank turmoil is an anticipated economic headwind, its impact has not discernably shown up in the data thus far.

At the same time, economic data out of Europe has been mixed to slightly softer, while China readings from April ([China Watch: Disappointing April activity data indicated weak momentum in recovery 16 May 2023](#)) have for now thrown some cold water on the reopening narrative that fueled some of this year's dollar bearishness.

Some of this can be observed in global economic surprise measures, where the relative change in G10 data surprises has generally correlated with G10 FX moves. Exhibit 1 shows the month-to-date change in economic surprise indices (Z scores) of other G10 economies (as well as China), relative to the US, vs. FX performance against the dollar. As the USD has appreciated broadly during this time, the biggest moves have generally been against currencies where data surprises have been worse relative to that of the US. This can be seen in Exhibit 2, where the surprise index gap vs the US has narrowed notably in the case of China and flipped vs the Euro area.

Exhibit 1: Relative econ data surprises Vs. FX performance

Recent FX depreciation greatest where data has been softening

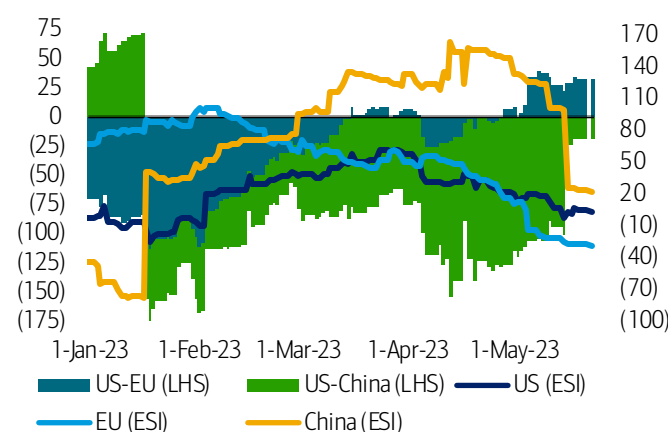


Source: BofA Global Research; Bloomberg

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Exhibit 2: Economic surprises: US, EU & China

Recent data misses more pronounced in EU and China



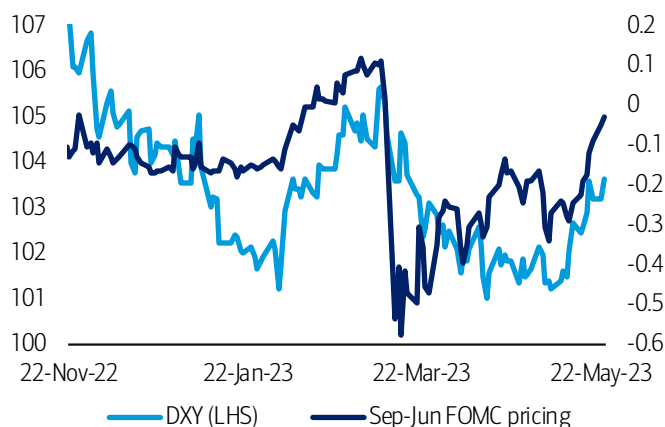
Source: BofA Global Research; Bloomberg

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Broadly consistent with this, the dollar's recent rally has also occurred amid a re-acceleration of US interest rates. As seen in Exhibit 1, the spread between market pricing for the September and June FOMC meetings has essentially come back to flat for the first time since the sharp repricing around the time of the banking turmoil in March. (Exhibit 3) This back-up in rates has been more pronounced in the US than abroad, prompting a re-widening of US interest rate differentials, which have tracked with the broader dollar rally. (Exhibit 4)

Exhibit 3: DXY & Sept-June FOMC pricing

dollar rally amid pricing out of Sept rate cuts

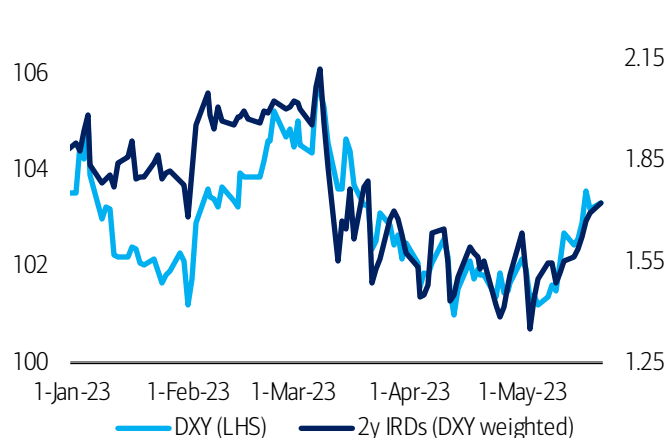


Source: BofA Global Research; Bloomberg

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Exhibit 4: DXY and 2Y rate differentials (DXY weighted)

Dollar rally tracking re-widening in rate differentials



Source: BofA Global Research; Bloomberg

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Commentary from some Fed officials during this time has also indicated that the balance of views on the committee favoring further hikes might be greater than previously thought. Presidents Mester, Bullard, Kashkari, Logan, and Governor Bowman have all (to varying degrees) recently expressed potential need for more hiking beyond current fed funds rate levels. Chair Powell struck a more balanced tone last week (“The risks of doing too much or doing too little are becoming more balanced”), while also reiterating the Fed’s data-dependent stance (“given how far we have come, we can look at the data and evolving outlook and make careful assessments”). [Recent commentary by Governor Waller](#) (see speech transcript) similarly emphasized the importance of upcoming data ahead of the June FOMC.

This continues suggest that the Fed may not be at terminal after all, and that key upcoming data releases (May NFP (non farm payrolls), CPI) ahead of the June FOMC could dictate the next move. Markets are currently pricing in ~35% chance of a 25bp hike in June, and a ~50% chance of at least a full hike by July.

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