FX Viewpoint

USD Year Ahead: A winding road to depreciation

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G10 FX Strategy
Global

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Key takeaways

- USD to depreciate in 2024, but more of an H2 story. Near-term upside risks remain and exuberant Fed pricing is moderating.
- US election a growing market theme, though USD implications are mixed and uncertainty remains. Premature to price in for now
- USD positioning mostly benign and short-term quant signals are bullish the USD. Our preferred expression is higher USD/CHF

USD: A winding road to depreciation

Our call is still for eventual USD depreciation this year amid a soft landing, but for FX this is more of an H2 story for now. Near-term upside risks are growing, and the exuberant pricing of Fed easing that weighed on the USD at the end of last year has moderated to start the year. While signs of a hard landing remain elusive, this too could put a potential floor on USD downside.

US Election: Potential upside USD risks, though pricing remains premature

As the primary season has begun, the potential for an administration change poses mixed but initial USD upside risks. That said, the full composition of government (divided vs. a sweep) will matter, and there is still a long way to go to November amid this uncertainty. Pricing for outcomes is premature, but planning is not.

Flows & positioning: Market neutral to slightly short USD

Both Hedge Funds and Real Money bought the USD in the past month—largely across the board and in line with the price action—following the sell-off in Q4. We find USD positioning neutral to slightly short, but exposure still lags the more bearish sentiment.

Quant: Short-term bullish USD/CHF

Latest short-term quant signals are bullish for the USD and our preferred expression is higher USD/CHF. Option flow shows increased demand for CHF puts vs both USD and EUR, and our CARS (Cross-Asset Regime Switching) model is bearish CHF on rates factor as DXY tests the 200d SMA (simple moving average) resistance. The risk to this view is a dovish Fed.

Vol: FX hedges for a Q1 USD bounce

In the risk scenario of a more prolonged Q1 USD rally driven by equity shock, 3m 25d USD risk reversals vs cyclical G10 currencies like AUD, NZD and CAD look attractive as hedges. In the risk scenario of a foreign data weakness-induced USD rally, we like to use a USD put calendar spread to cheapen the cost of owning long-dated USD puts.

USD: a winding road to depreciation

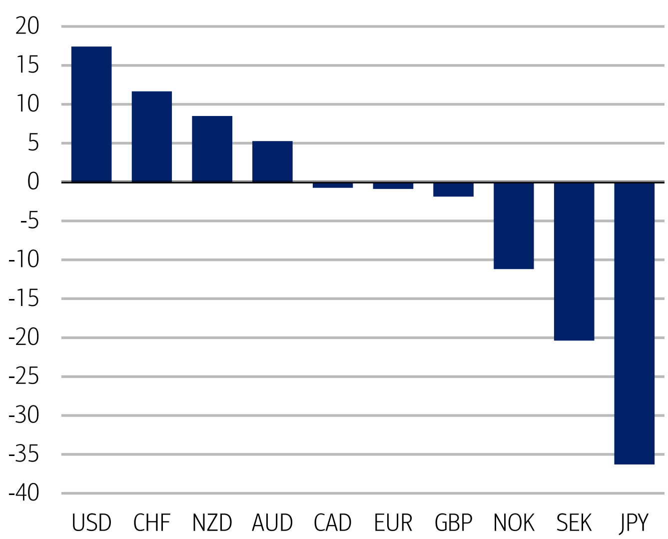
2023 ended with USD sentiment taking a hit, as markets squarely focused on the impact of the Fed's perceived "dovish pivot" at their December meeting. Overall, moderating inflation data in the US against the backdrop of a softening but healthy labor market has given credence to the "soft landing" camp, even if it still feels too good to be true. This is consistent with our Economics view, where we see no recession in 2024 and the Fed embarking on a gradual cutting campaign starting in March (see US Economic Viewpoint: Sticking the landing 18 December 2023).

From an FX perspective, we view this scenario as ultimately USD negative, all else equal, as Fed easing (to prevent real rates from rising) amid a resilient growth backdrop should be broadly supportive of risk assets. Over time, this should allow space for the USD to move towards equilibrium from still overvalued levels. (Exhibit 1) As such, our 2024 and 2025 USD forecasts continue reflect our expectations for broad depreciation by year-end.

That said, as demonstrated by price action this year, some upside USD risks are mounting, and we think it will take time for this process to get fully underway. As seen in Exhibit 2, our forecasts imply most of the USD's depreciation this year occurring in the second half. Near-term upside risks remain, as the market contemplates still resilient US economic data, exuberant Fed easing expectations, easing US financial conditions, geopolitical risks, and the implications of both a seemingly lower-likelihood "hard landing" outcome as well as the outcome of the US election – one of the year's biggest "known unknowns".

Exhibit 1: Misalignment from equilibrium, G10 REER, IMF model (positive for overvalued)

The IMF model suggests USD, CHF most overvalued, JPY, Scandies most undervalued, in real effective terms in G10



Source: IMF, Bloomberg, BofA Global Research

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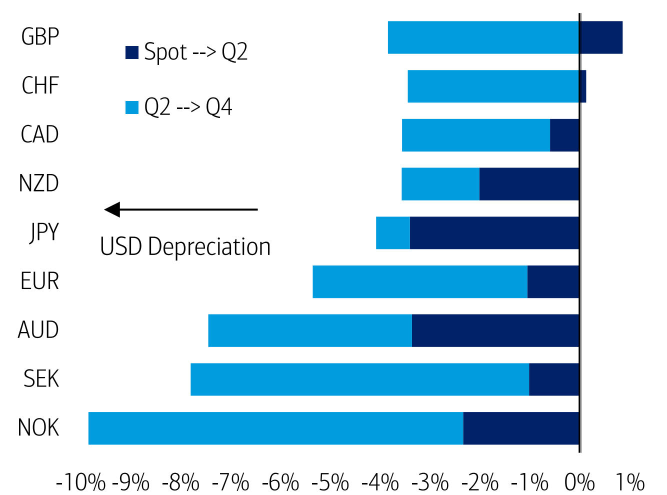
Exhibit 2: BofA FX Forecasts: Implied USD move through YE 2024

We see 2024 as a year of USD depreciation, though mostly during H2



Source: BofA Global Research; Bloomberg

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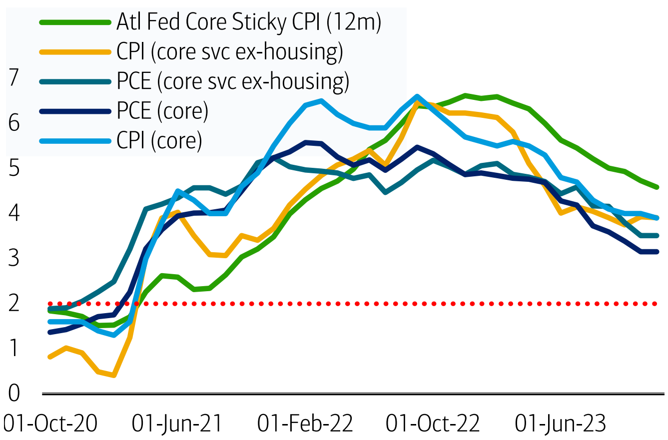
Resilient data and easing financial conditions

As we start the year, the USD's outlook has become more nuanced. Many in the market are still looking for the Fed's easing campaign to start as early as March, although exuberant expectations reflected in front-end rates at times have looked more like a backdrop for a "hard" landing scenario, rather than the "soft/no"-landing conditions that prevail at present.

The data picture in the US continues to demonstrate overall economic resilience. While inflation is indeed coming down, upside risks can't be ruled out, particularly as they relate to both the core services sector (Exhibit 3), as well as potential pass-through of energy/shipping prices due to Middle East turmoil (see Global Economic Viewpoint: Global rate cuts lost at (Red) Sea? 12 January 2024). Meanwhile, labor data in the US is softening in some respects (downside NFP (non-farm payrolls) revisions, narrowing of sectors in expansion), but the unemployment rate remains near the lows of the past several decades, and higher-frequency unemployment claims have been trending downward since last summer and have tended to undershoot expectations (Exhibit 4).

Exhibit 3: Select measures of US inflation

Inflation continues to broadly trend lower; services still tracking above core PCE



Source: Bloomberg; BofA Global Research

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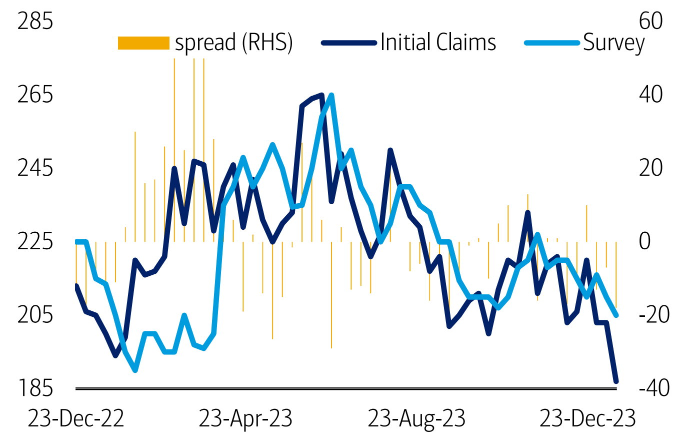
Exhibit 4: US Initial unemployment claims (actual and survey)

Claims continue to trend lower, below consensus expectations



Source: Bloomberg; BofA Global Research

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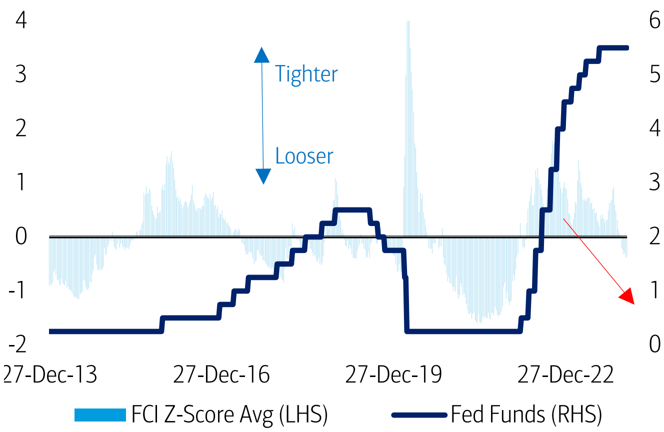
Meanwhile, measures of financial conditions continue to ease as markets generally anticipate less monetary restrictiveness. While financial conditions in-and-of themselves are not a direct input to monetary policy, it was their tightening last year that several Fed officials flagged as a possible substitute for further rate hikes. Current financial conditions are not “easy” by historical standards, per se, but the incremental easing that has occurred over the past few months could be seen as a reason for the Fed to take a more measured approach to policy easing.

Exhibit 5 shows that the average Z-score measures of the Bloomberg, Chicago Fed and Goldman Financial Condition Indices (10y lookback) have just recently turned negative (easier conditions) for the first time since this hiking cycle began. Indeed, US equities at/near all-times highs, IG credit markets remaining resilient (Credit Market Strategist: When the stars align 19 January 2024), and nascent signs of housing market optimism are emerging, driven by lower mortgage rates (see Homebuilders: Housing starts slowed in December, but permits steadily rose MoM and YoY 18 January 2024) (Exhibit 6).

Exhibit 5: Average Z-Score of 3 common financial conditions measures (Bloomberg, Goldman, Chicago Fed)

US financial conditions continue to loosen from tighter levels last year



Source: Bloomberg; BofA Global Research

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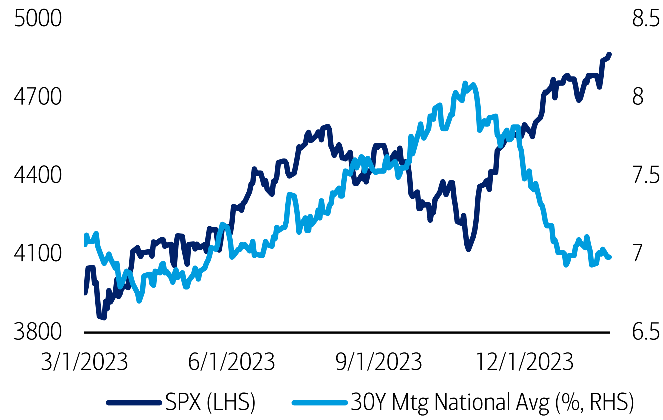
Exhibit 6: S&P 500 & 30Y national avg mortgage rate (%, RHS)

Select components of financial conditions indices continue to ease



Source: Bloomberg; BofA Global Research

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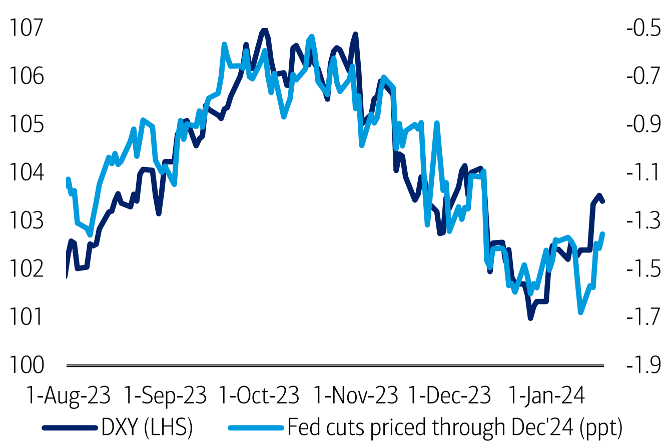
Exuberant Fed pricing has moderated

Consistent with this ongoing data resilience, recent Fed commentary has reflected a more balanced policy outlook, resulting in moderation in Fed pricing (see Liquid Insight: USD: Defying gravity 17 January 2024). Indeed, dating back to the end of December, Fed expectations have vacillated, and the USD has moved accordingly. For example, probability of a cut in March based on market pricing touched as high as 90% at one point in late-December, but has reverted to roughly 45% now (Exhibit 8). Similarly, the total cuts priced in for 2024 reached as high as ~170bp in mid-January, before paring back to the roughly 135bp of cuts priced in today (Exhibit 7).

Exhibit 7: DXY & Fed cuts priced through 2024 (fed funds futures)

The dollar has rallied to start the year as the pace of expected Fed cuts have moderated



Source: BofA Global Research; Bloomberg

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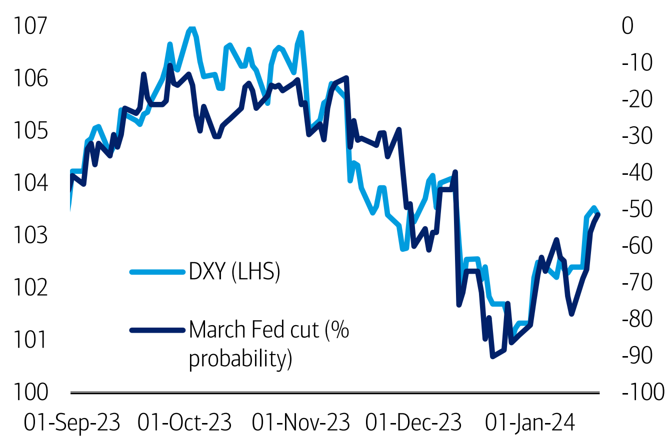
Exhibit 8: DXY and odds of a March Fed cut implied by fed funds futures

The dollar has rallied to start the year as the odds of a March cut has moderated



source: BofA Global Research; Bloomberg

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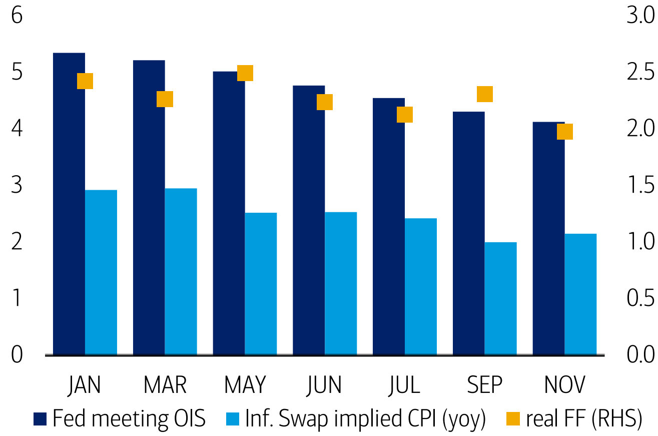
While still over one full cut more than the four cuts our economists are forecasting for 2024, this path is more in line with the gradual decline in inflation expectations for each meeting date this year, as proxied by the implied CPI on inflation swap trade data (Exhibit 9). Longer out, however, 5y5y USD inflation swaps have reversed nearly half the decline since last November, and while levels are still within ranges of the past few years, the move highlights possible upside risks (Exhibit 10).

Exhibit 9: OIS Pricing per '24 Fed Meeting & implied CPI from US inflation swaps

Expected Fed pricing to decline along with expected disinflation



Source: Bloomberg; BofA Global Research

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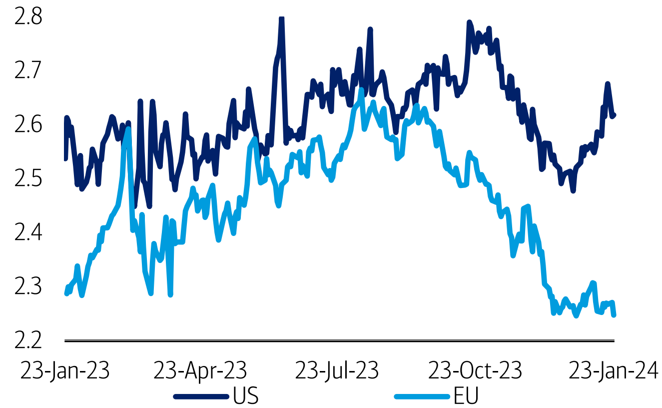
Exhibit 10: US & EU 5y5y inflation swaps

US forward inflation pricing trending higher though still within recent ranges



Source: Bloomberg; BofA Global Research

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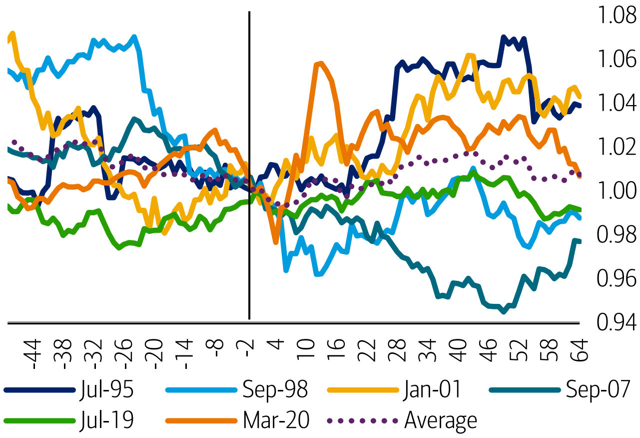
With that in mind, it is necessary also to view Fed pricing not solely as a pure measure of modal expectations, but also reflecting some smaller probability of a much deeper level of cuts, likely in response to a hard landing type recession. Declines in front-end rates is USD negative as a first order reaction, although there are limits to this. Indeed, as Governor Waller noted in his speech (see Fed press release) last week, "*… In many previous cycles, which began after shocks to the economy either threatened or caused a recession, the FOMC cut rates reactively and did so quickly and often by large amounts. This cycle, however, with economic activity and labor markets in good shape and inflation coming down gradually to 2 percent, I see no reason to move as quickly or cut as rapidly as in the past.*" This could also speak to some of the dollar's resilience in the face of the most recent aggressive Fed pricing, which seemed out of sync with the overall economic data flow and outlook.

Lookback: USD performance during previous cutting cycles and recessions

With the likely start of the cutting campaign growing closer, it is informative to look at the USD's performance following past instances of the first Fed rate cut being realized. As seen in Exhibit 11, from the onset of the first Fed cut, DXY performance has been mixed over the past six cycles, and on average has been relatively flat over the ensuing quarter. These individual dollar moves mostly (but not always) occurred in line with interest rate differentials (US-German Sovereign; Exhibit 12). This is due in large part to the USD's perceived "safe haven" status and its negative correlation to risk, as cutting cycles have often been associated with recessions.

Perhaps most interestingly, the dollar's biggest decline following the first cut occurred after the September 2007 cut. This, of course, was the cut that kicked off an eventual near-decade of ZIRP (zero interest rate policy) and significant Fed balance sheet expansion, at a time when the crisis was much more of a US rather than global economic event. The most recent shock – the cutting cycle associated with COVID – was much more global at the onset, thus keeping the USD initially supported. This time, of course, with soft landing as our base-case, we see the US economy more likely to recouple with the rest of the world after outperforming for much of 2024, bringing the USD lower.

Exhibit 11: DXY performance following the 1st Fed cut of cycle (#days, indexed to 1)
First Fed cuts have produced varied DXY performance over subsequent quarter



Source: Bloomberg; BofA Global Research

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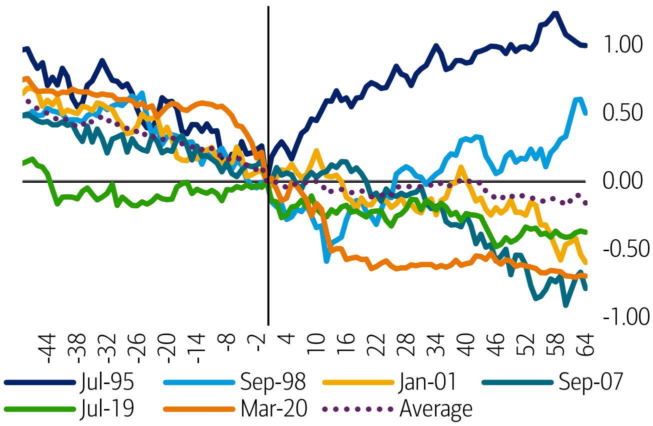
Exhibit 12: US-GE 2y differential change following the 1st Fet cut of cycle (#days, cumulative ppt change)
First Fed cuts have mostly seen US-GE rate differentials narrow



Source: Bloomberg; BofA Global Research

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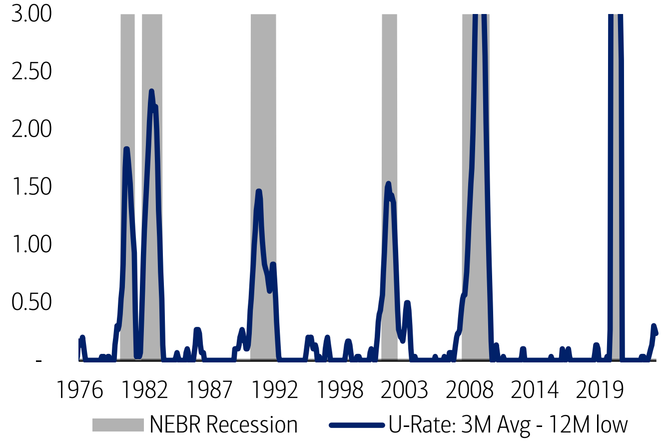
Finally, as noted above, the current economic backdrop is far from indicating any imminent risks of a hard landing. While it was not too long ago that a recession in 2024 was seen as a foregone conclusion, data thus far has proven otherwise, and the soft-landing path has widened considerably.

Nevertheless, it is worth considering the immediate implications that a "hard landing" would have on the FX market, as it challenges the notion that deeper rate cuts will translate to dollar depreciation. Here, the past can be informative. One metric that has received notable attention recently has been the Sahm rule, which observes that when the three-month average unemployment rates rises by at least 0.5 percentage points compared to the 12-month low, recessions have ensued (Exhibit 13). We observe that over the past six instances of the Sahm rule being triggered, the USD has appreciated four times, for an average of +5% over the ensuing six months (Exhibit 14). Again, this further demonstrates the USD's perceived "safe haven" allure, and poses upside risks to our bearish forecast.

Exhibit 13: 3m rolling average US unemployment rate – previous 12m low

Sahm rule: Recessions occur when this figures crosses 0.5



Source: Bloomberg; BofA Global Research

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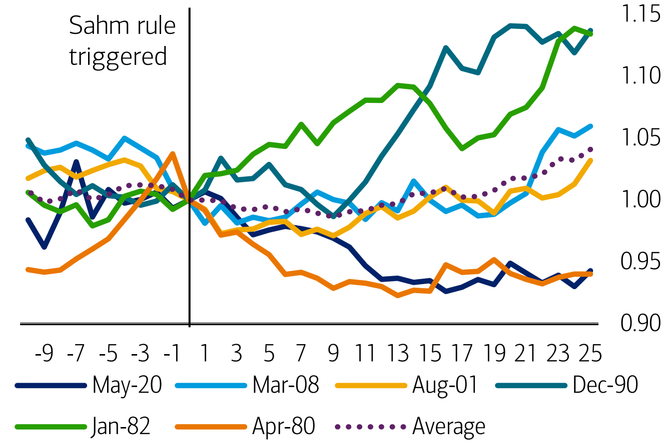
Exhibit 14: DXY performance following past 6 Sahm Rule triggers (# of weeks; indexed to 1)

USD has rallied on average of 5% over subsequent 6 months of this recession indicator



Source: BofA Global Research; Bloomberg

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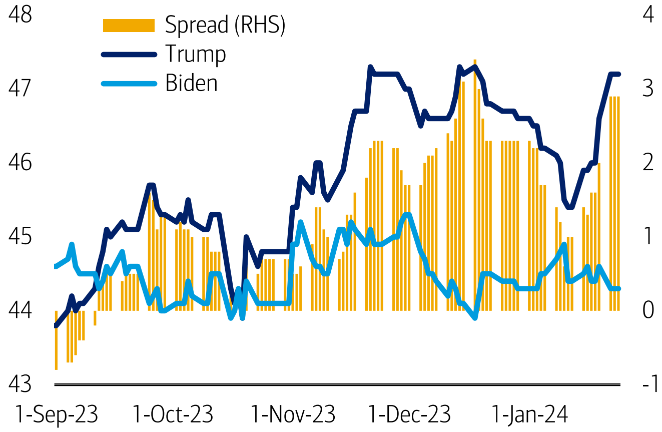
US Election: Upside USD risks, though pricing premature

With the Iowa caucus and New Hampshire primary now in the rear-view mirror, the US presidential election is beginning to captivate financial markets. Although with the general election still almost ten months away, it still seems premature for these incremental developments to be a sustainable driver of the dollar, especially as the implications are not straightforward. Nevertheless, the market seems in search of a fresh theme beyond watching the Fed, and this is among the most "known unknowns" in 2024.

We consider potential policy impacts from the leading candidates. As it stands today according to a broad aggregation of polls and betting markets by Real Clear Politics, former President Trump appears to have the edge over President Biden in November, and this appears to have ticked up since the Iowa caucus (Exhibit 15, Exhibit 16).

Exhibit 15: Real Clear Politics US presidential poll (% average)
Former President Trump's lead ticked up post-Iowa caucus



Source: Bloomberg; Real Clear Politics, BofA Global Research

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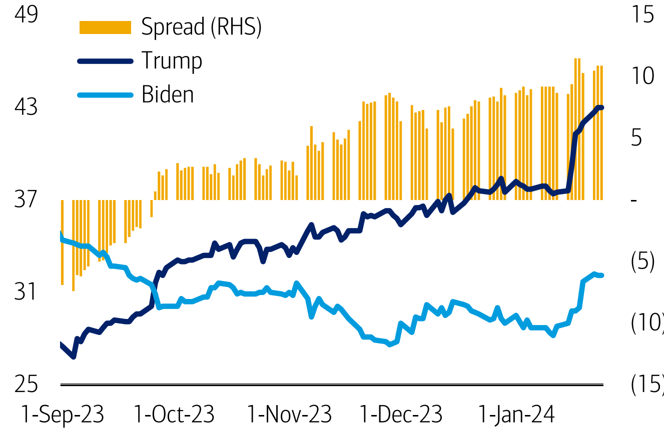
Exhibit 16: Real Clear Politics US presidential betting odds (% average)
Former President Trump's betting odds ticked up post-Iowa caucus



Source: Bloomberg; Real Clear Politics, BofA Global Research

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At this stage, it seems reasonable to think of a President Biden re-election as mostly status quo from the market's perspective, whereas a more material shift in potential legislation is more likely under the re-election of former President Trump. An equally relevant factor for possible policy shifts will be whether the November elections produce a divided government or a single party sweep. Again, this is premature, but a divided government should serve to dilute the possible impact of the more extreme policy shifts, all else equal.

A regime change could be a USD positive event, at least initially, but ultimately the implications are more mixed. In our Year Ahead report (Global Macro Year Ahead: Hope for the best, prepare for the worst 19 November 2023), we highlighted several areas where policy could shift.

Exhibit 17: The outcome of the election has different implications for key policy issues
Hypothetical US election scenarios

Key Issue	Republican Sweep	Democratic Sweep	Divided Government, Republican President	Divided Government, Democratic President
Fiscal policy	Looser (tax cuts)	Looser (spending increases)	Neutral (Gridlock)	Neutral (Gridlock)
Trade policy	Increased use of tariffs and tech restrictions	Tech restrictions	Increased use of tariffs	Ongoing restrictions tied to technology
Monetary policy/Fed	New chair, more political pressure	Possible, still independent Fed	New chair, political pressure	Possible, still independent Fed
Climate policy	Reversal of climate agenda	Expansion of climate agenda	No change (Gridlock)	No change (Gridlock)
Foreign Policy	Increased risk of isolationism	Increased engagement with US allies	Increased risk of isolationism	Increased engagement with US allies

Source: BofA Global Research

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In terms of FX, on the USD positive side of a regime shift, several proposed policies could be seen as inflationary, keeping an upside bias to US rates, all else equal. These include:

- **Trade** – The potential for increased tariffs with China and other protectionist measures could raise import prices and serve as a headwind to global growth.

- **Foreign Policy** – A push towards greater US isolationism amid an already fragile backdrop would elevate geopolitical risks and raise the possible path of global energy prices.
- **Immigration** – A more aggressive approach to curbing immigration could act as a headwind to labor supply at a time when labor market conditions have been coming closer back into balance.
- **Fiscal** — The lack of appetite for fiscal consolidation and prospects for renewed tax cuts would point to upside growth and inflation risks, putting an upward bias on US rates.

That said, there are some potential countervailing implications for the dollar, although these might take longer to unfold. These include:

- **De-regulation** – A greater push for more a "market friendly" regulatory regime could be supportive of risk assets, and, by extension, higher beta currencies.
- **Fiscal** – Similarly, more expansionary (or less contractionary) fiscal could be supportive of risk appetite.
- **Monetary policy outlook**— Based on past commentary, pressure on the Fed to run an otherwise looser monetary policy than warranted would likely continue, presenting clear downside USD risks. Further, Powell's term as Chair is up in 2026, and former President Trump has stated he would look to appoint a new nominee, likely one that would lean decidedly dovish.

Economic data and the Fed's ultimate reaction function should continue to supersede these factors over the next few quarters, although risk premia could gradually build as the year (and election outlook) progresses.

Positioning: Market neutral to slightly short USD

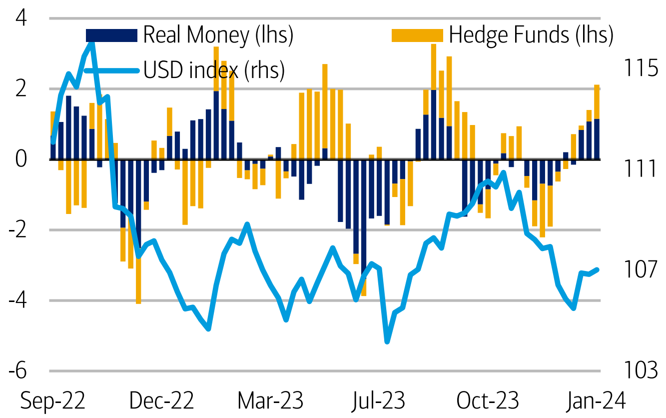
Both Hedge Funds and Real Money bought the USD in the past month, having done so largely across the board and in line with the price action (Exhibit 18, Exhibit 19).

While Real Money investors pared back some of their USD shorts after selling the USD in Q4, Hedge Funds added to their longs in recent weeks, and their net USD flows in Q4 were neutral (see LCBF 22 Jan 24 and FX flows & positioning in 2023 19 Jan 24).

We find the USD positioning neutral to slightly short (Exhibit 20) once we also onboard signals from our FX & Rates Sentiment survey and the CFTC (Commodity Futures Trading Commission). In fact, we find most G10 FX positions light and none too heavy.

We should flag that, while our investors' USD bearishness stands out on a longer time frame, their exposure does not stand out as much (Exhibit 21 and FXRS 12 Jan 24 (see report)). To us, this suggests there is room for the USD to sell off more sustainably later this year and after the market has priced properly the Fed stance and several other risks.

Exhibit 18: BofA investor 4-week USD flows (z-score) and USD TWI
Investors bought the USD in the past month following the Q4 sell-off



Source: BofA Securities, Bloomberg

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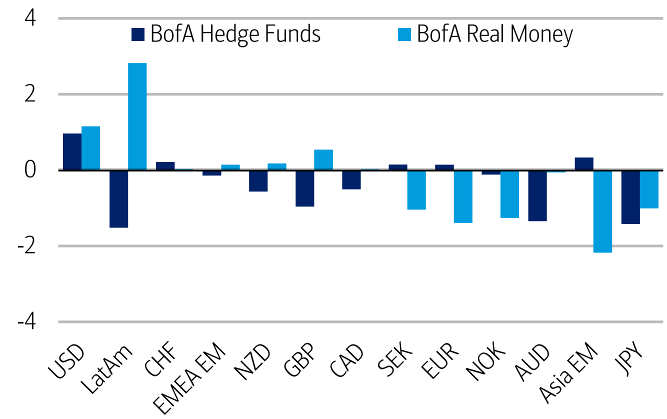
Exhibit 19: BofA investor FX flows in past 4 weeks (2-year z-score) text
BofA investors supported the USD largely across the board in the past month



Source: BofA Securities

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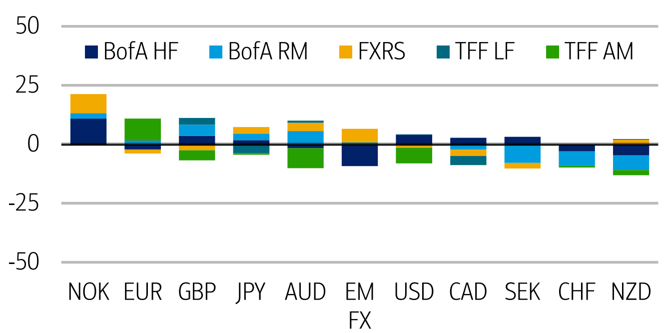
Exhibit 20: Latest aggregate G10 FX positioning by component
USD positioning is neutral to slightly short



Source: BofA Securities, Bloomberg. Aggregate positioning is the equally-weighted average of five inputs (BofA Hedge Funds, BofA Real Money, a signal from our monthly FX & Rates sentiment survey, TFF Leveraged Funds, TFF Asset Managers). Each signal is scaled to +50 and -50. Where fewer than five inputs are available (Scandies, CHF, EM FX), aggregate positioning assigns equal weights to all available inputs. .For details, please see LCBF: Primer 26 May 2021

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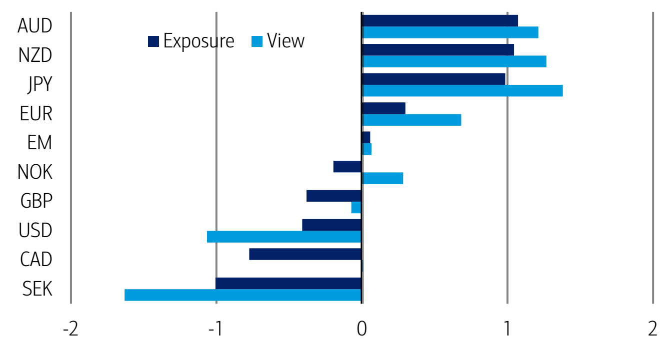
Exhibit 21: Full period FX Exposure & View (z-score)
USD bearishness stands out on a longer time frame but exposure less so



Source: BofA Global Research FX and Rates Sentiment Survey; Note: Data for FX Exposure starts in January 2004 for USD, EUR, GBP, JPY, CAD and EM, while for AUD, NZD, NOK and SEK the start date is January 2016; Data for FX View starts in December 2011 for USD, EUR, GBP, JPY, CAD and EM, while for AUD, NZD, NOK and SEK the start date is January 2016

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Quant: short-term signals are bullish USD/CHF

Short-term quant signals turned bullish for USD

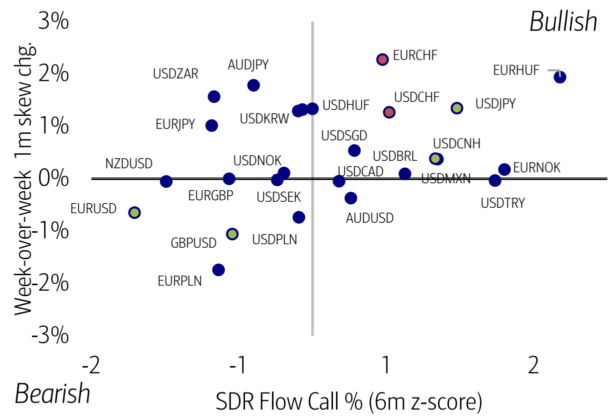
Our latest short-term quant signals are bullish for the USD, and trend-followers who trade FX similarly to our quant framework may continue to buy the USD in the coming week (see Systematic Flows Monitor: 19 January 2024). Last week's option flow and skew move show demand for USD calls vs G10 majors (Exhibit 22). This quant-based analysis has bullish continuation signals for several USD uptrends in both G10 (vs JPY) and EM (vs ZAR, HUF, KRW, and CNH) space (see FX Quant Insight: 22 January 2024). Last week, interest rate differentials also moved in favor of the USD vs G10 FX (ex-CAD, see Exhibit 23). US-based investors remain short USD year-to-date, but demand for the USD from Europe and Asia trading hours has been driving the USD higher.

CHF may be the most compelling short leg for any bullish USD view

We prefer to express any bullish USD view against CHF for the near-term. Option flow shows demand for CHF puts against both the USD and EUR (Exhibit 22). Our CARS model is also bearish CHF in G10, given yields rose broadly by more for other currencies (Exhibit 23). We believe bearish CHF for 2024 is a consensus view (see Liquid Insight: 10 January 2024) that has not been fully reflected in the positioning (see Liquid Cross Border Flows: 15 January 2024) and price actions. Risk to our view would be dovish FOMC leading to broad-based USD sell-off.

Exhibit 22: Latest options flow moved for USD calls and CHF puts

1m skew change vs call percentage z-score



Source: BofA Global Research, DTCC. Note: CNH flows are proxied by "CNY" flows in SDR.

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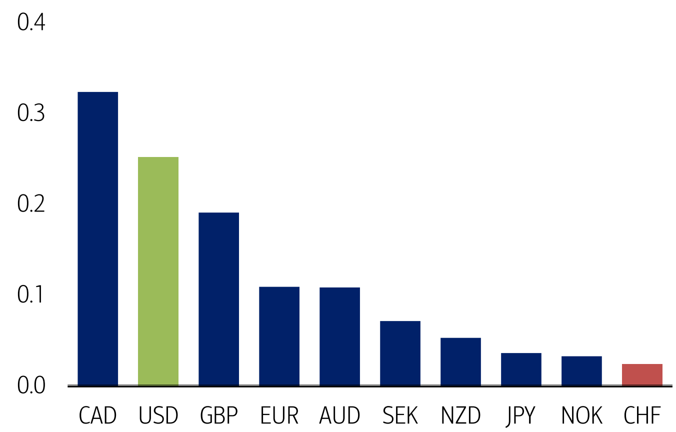
Exhibit 23: 2y yields broadly increased but by the least amount for CHF last week

2y global yield change



Source: BofA Global Research, Bloomberg

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Vol: FX hedges for a Q1 USD rally

As noted above, our base view for 2024 as whole is the USD has more room to sell off by year-end, and in the short-term the bearish USD view appears to be consensus with investors now net short. Coupled with our short-term bullish USD quant signals, a more prolonged Q1 USD rally is worth hedging, in our view.

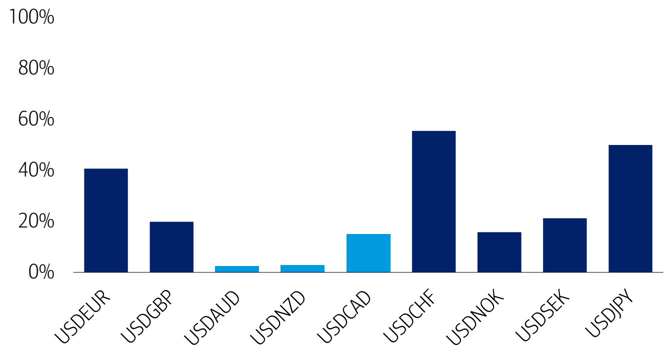
3m USD risk reversals vs AUD, NZD and CAD to hedge equity-driven USD rally

We believe a USD rally in Q1 is more likely driven by an equity risk-off shock than higher US yields. In US equities, 4Q23 return already ranked at a stretched 94th percentile since '99, and the asset continued to rally to a new high this month. As for rates, a 25bp dip in 2yT yield below the 200d SMA like we saw in December 2023 historically has signaled the start of cyclical downtrend (see FX Viewpoint: 16 January 2024).

3m 25d USD risk reversals vs cyclical G10 currencies like AUD, NZD and CAD look attractive as hedges for a scenario of an equity-driven USD rally. Since the 4Q23 USD sell-off, short-dated risk reversals in these pairs have tilted to historically stretched levels for USD puts (Exhibit 24). Cyclical currencies tend to weaken more vs the USD during risk-off equity sell-offs and this should lead to some normalization of risk reversal for USD calls. Risks to this structure would be a resilient equity market in 1Q23.

Exhibit 24: Short-dated risk reversals are most stretched for USD puts vs AUD, NZD and CAD

10y percentile of 3m 25d risk reversals (as % of atm vol) for USD vs G10 FX



Source: BofA Global Research, Bloomberg

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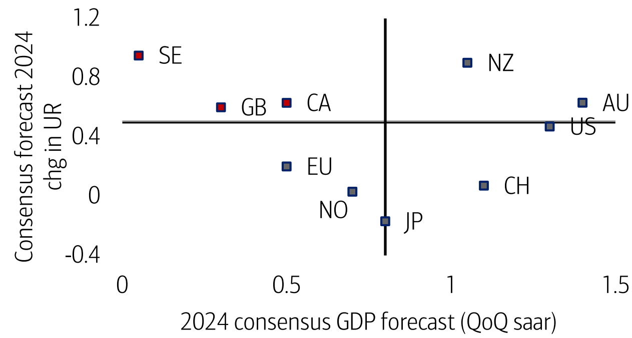
Exhibit 25: 2024 Consensus outlook is most bearish on growth and employment for Sweden, Canada, and UK in G10

'24 Consensus GDP forecast vs consensus forecast implied chg in UR



Source: BofA Global Research, Bloomberg

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Hedge global data vulnerability with USD put calendar spread

The USD may also rally in scenarios of material deterioration of macroeconomic data outside of the US, in a potential replay of the 3Q23 dynamic of widened US vs RoW growth differential. In G10, Canada and Sweden appear to be the most vulnerable. In '23, Canada, Sweden, and New Zealand saw above average pick-up in unemployment rates vs G10 peers and negative growth. Looking ahead into '24, consensus forecasts continue to anticipate further above average UR increases and below average annual growth for Sweden and Canada (Exhibit 25). 2024 data forecast is also bearish for the UK, but we believe the GBP may be supported with rates market converging to our call of two Bank of England rate cuts this year (see GBP in '24: 15 January 2024).

For this scenario, calendar spreads can be used to cheapen the premium of owning longer-dated USD puts (e.g., sell 3m USD put and buy 9m USD put). The calendar spread structure could provide ~50% premium saving for investors who believe a near-term USD rally may take place due to foreign economic data weakness but still see the USD weaker over the medium term. The risk to this scenario would be resilient non-US economic data and a USD sell-off earlier vs later in '24.

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