FX Viewpoint

Buying the FX vol dip

08 April 2024

G10 FX Strategy
Global

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DXY: US Dollar Index

SMA: simple moving average

OTMF: out-of-money forward

ATMF: at-the-money forward

BoC: Bank of Canada

RBNZ: Reserve Bank of New Zealand

Weak directional conviction is reflected in forecasts

FX consensus forecasts for year-end are the closest they have ever been to prevailing spot prices in this rate cycle. Notably, '24 year-end consensus forecasts are only 1.8%, 1.6% and 0.3% away from current spot for EURUSD, GBPUSD, and USDCHF. Forecasters are making minimal directional calls for '24, which reflects the broad market's persistently weak directional conviction since the start of the year. This uncertainty over different macro outcomes has driven FX vol lower year-to-date. However, the levels of medium-term implied vols are attractive to own after the recent fall, in our view.

Implied vols at 6m-9m tenors have sold off too much

We prefer owning 6m ATMF EURUSD or GBPUSD straddles. Current pricing for the straddles is 3.2% and 3.7%, respectively, lower than both our forecasted moves over this horizon (3.6% for EURUSD and 5.4% for GBPUSD vs 3Q24 forecast) and the typical 6m moves for both currencies (the median long-run 6m move is 5.1% for EURUSD and 4.2% for GBPUSD). Implieds at the 6m-9m tenors are now around 1 vol below same-tenor realized vols. Implied-realized spreads of this magnitude tend to not persist for long. At the same time, 6m EURUSD implied vol has dipped below 5th percentile. At this level, EURUSD implied vol would rise over the subsequent 6-months period by an average of +1.7 vols 87% of the time. A potential pick-up in implied vols once FX market converges to a macro direction would increase the likelihood for straddles to become in-the-money. On the back of these views, we enter a 6m ATMF EURUSD straddle for 3.3558% EUR (expiry Oct 7 '24, strike 1.0880, spot ref 1.0804, vol ref 6.019). Risk would be continuation of the broadly low vol regime for rest of '24 as investors' reluctance to make directional FX trades persists. For a full list of our open trades and trades closed over the past year please see G10 FX Weekly (Global FX Weekly, 5-Apr-2024).

1y USD skews to reprice higher if no Fed cut in June

The June FOMC could serve as a catalyst for renewed directional conviction in FX market. Our US economists currently expect the first Fed rate cut of this cycle to take place in June. The rates market pricing has also settled around this scenario for now. Despite the year-to-date USD spot rally, bearish USD positions at the 1y tenor have largely not budged. However, should the June rate cut not materialize, long-dated USD skews would likely reprice broadly higher for USD calls. Under this scenario, we would expect CAD and NZD to be the most vulnerable to the skew move. 1y skew levels are currently lower than USD/G10 average for CAD and NZD, and our economists expect the most aggressive rate cut path for BoC and RBNZ in G10 this year. 1y USD/CAD and USD/NZD skews would likely move by at least 3% in favor of USD calls to reverse back to 3Q23 levels and to reflect the diverging monetary policy path between the Fed and BoC/RBNZ over the next year. Risk to the scenario would be the Fed follows its own dot plot and cuts rate in June as market currently prices.

Timestamp: 08 April 2024 12:01AM EDT

FX forecasters are hesitant to make big calls in 2024

Year-end '24 FX forecasts are the closest they have been to spot in this cycle

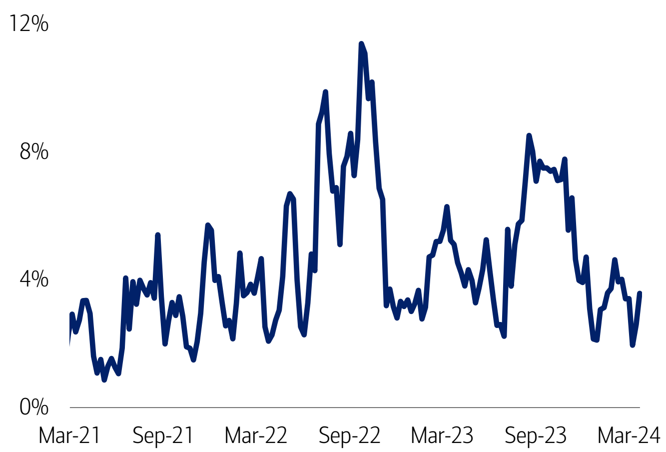
On average, the USD would move by 4.6% over a 6-months period and by 5.7% over a 9-months period against G10 currencies. FX investors tend to look to these "rule-of-thumbs" as anchors when formulating medium-term currency forecasts. In March the consensus USD/G10 forecasts for '24 year-end were tightest to spot since 2022 by only 2.0pp (Exhibit 1). In our view, the current spread of 3.6pp vs. spot is still tight vs. recent history, indicating that the consensus likely underprices implied volatility.

Except for USDJPY, consensus forecast is projecting smaller spot directional moves than the historical medians for eight out of nine USD/G10 pairs (Exhibit 2). In particular, consensus forecast for year-end is only 1.8%, 1.6% and 0.3% away from current spot levels for EURUSD, GBPUSD, and USDCHF.

The proximity of year-end forecasts to current spot levels continue to reflect investors' low conviction for the macro direction in '24. A bearish USD consensus was formed at the end of '23 (see FX Viewpoint: 16 Jan 2024), but persistently strong activity data and resilient inflation data in the US so far this year has pushed the market to reassess the view for '24. For the time being, our latest FX & Rates Sentiment Survey shows equal weighting between long USD and short USD convictions from respondents for '24 (see FX and Rates Sentiment Survey: 15 Mar 2024), highlighting the bimodal stance among FX investors.

Exhibit 1: USD/G10 consensus FX forecast is the closest it has been to prevailing spot in this rate cycle

Average magnitude of USD/G10 (ex-JPY) moves for rest of the year as implied by year-end consensus forecast



Source: BofA Global Research, Bloomberg

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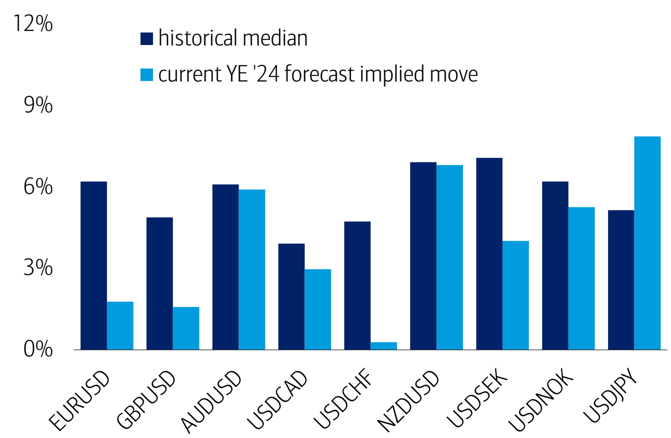
Exhibit 2: Consensus forecast has low expectation for directional spot moves this year except for USDJPY

Magnitude of USD/G10 spot moves implied by year-end '24 consensus forecast vs historical median 9m realized magnitude of spot moves



Source: BofA Global Research, Bloomberg

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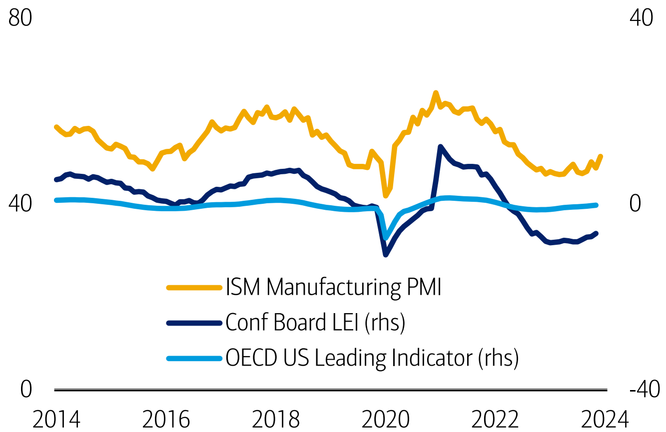
We see the market indecisiveness as averaging two-tailed risks

In the soft-landing scenario, we see weaker USD amid Fed cuts. Our fundamental strategy view is US recoupling to rest of the world, both in terms of growth and policy rate, pushing the USD down from an overvalued level (FX Viewpoint: G10 FX Year Ahead, 20-Nov-2023). In the delayed-landing scenario, we see stronger USD as the Fed stays on hold. If US decoupling continues, divergent monetary policy would support the USD through 2024. At current cheap levels of implied vol, investors don't have to commit to a single scenario. Going into June, there are genuine two-sided risks for FX that cannot be discounted in our view.

Recent leading indicators suggest a renewed expansionary business cycle in the US (Exhibit 3). Rates and equity markets have moved in accordance with this kind of cycle dynamic, as US equity sharply rallied since Q4 '23 and Treasury yield curve bear steepening (US Rates Watch: 03 April 2024). Should the Fed still cut policy rate amid renew growth optimism, FX market should enter a bearish USD and risk-on environment that is aligned to the soft-landing scenario. If the Fed delays the rate cutting cycle amid resilient US growth this year, the combination of exceptional US growth and positive USD carry would be bullish for the USD relative to other G10 peers whose central bank are still likely to start the rate cutting cycle in 2024. Amid unexpected growth pick-up and uncertainty over inflation, FX investors continue to waver between the fine line of "US exceptionalism" and "US debasement" that Michael Hartnett has coined at the start of Q4 '23 (The Flow Show, 29-Sep-2023).

Exhibit 3: Leading indicators show US economy is broadly recovering
Various economic leading indicators for US



Source: BofA Global Research, Bloomberg

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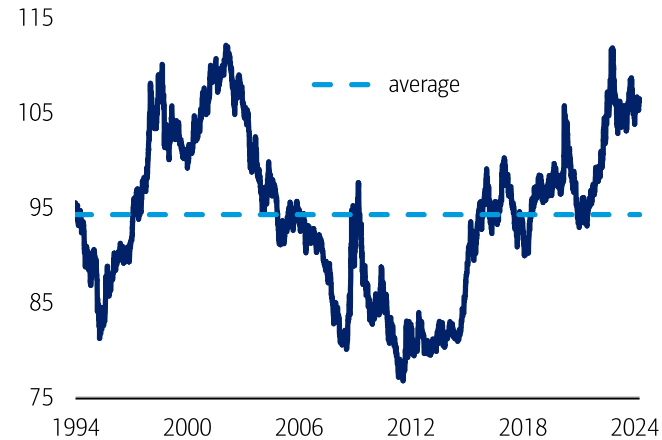
Exhibit 4: USD is still significantly overvalued vs REER equilibrium
Broad USD real effective exchange rate vs 30y average



Source: BofA Global Research, Bloomberg

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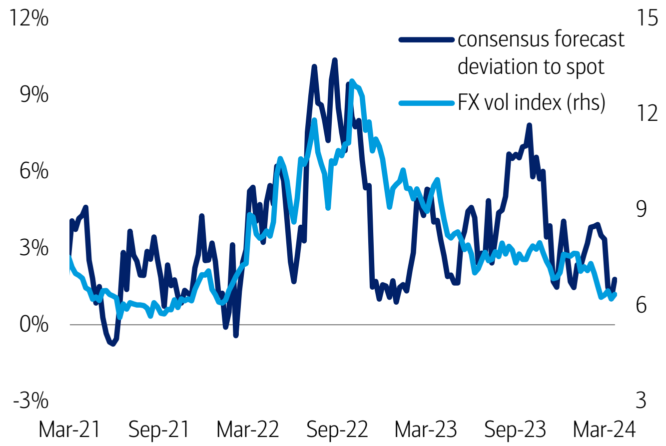
Forecast tightness is also inconsistent with valuations
Another way to gauge how big future FX moves may be is to consider FX equilibrium. If the spot is close to the equilibrium level, it may be reasonable to expect mean zero moves. However, the USD remains historically overvalued and we expect the equilibrium forces to offer a tailwind for the USD downtrend. The USD real effective exchange rate is around 5-7% overvalued compared to the past decade (Liquid Insight: 28-Mar-2024 and see Exhibit 4).

Lack of spot trend conviction is suppressing FX volatility
Uncertainty over G10 central bank policy directions for the year has compressed rate differential vol, which drove FX vol lower in 1Q24 (see Liquid Insight: 26 Mar 2024). Exhibit 5 shows market's low confidence in directional spot trend moves has likely also contributed to the current low vol regime in FX market. Levels of implied vols in G10 are now at a low enough level that investors should consider owning FX vol directly, in our view. Across the G10 FX vol curve, we find implied vol to be the cheapest at the 6m to 9m tenors (Exhibit 6).

Exhibit 5: Low investor expectation for spot trend move has suppressed FX volatility
Rolling year-end consensus forecast-implied EURUSD move vs FX vol index



Source: BofA Global Research, Bloomberg

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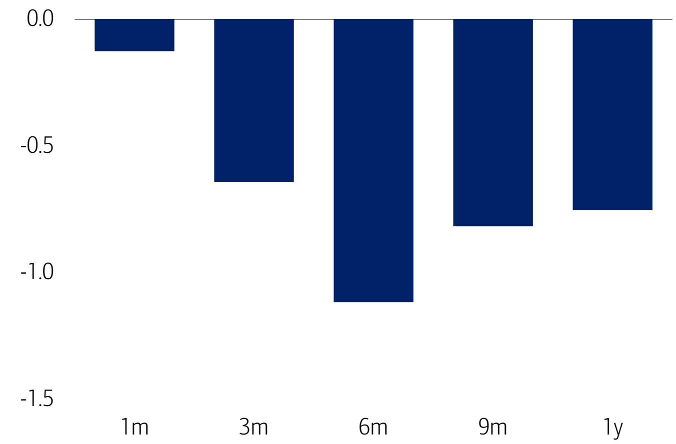
Exhibit 6: FX vol market prices-in least amount of vol premium at the 6m-9m tenors
Average USD/G10 implied-realized vol spread across tenors



Source: BofA Global Research, Bloomberg

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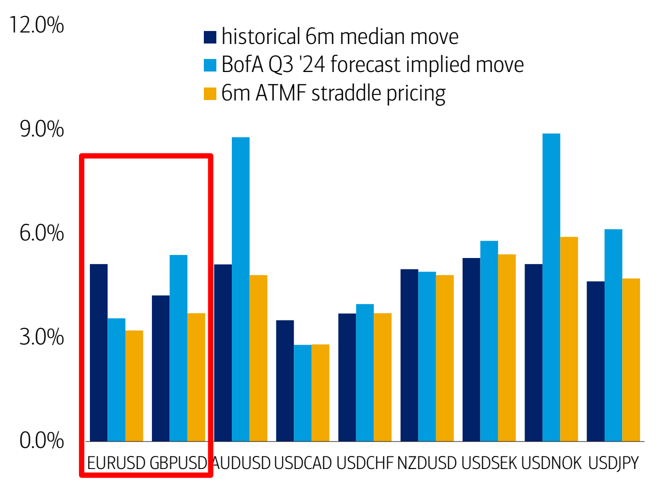
FX implied vols at the 6m-9m tenors are dislocated

As the FX vol term structures are broadly steep, levels of short-dated implied vols are lower than medium to long-dated implied vols. However, we believe short-dated implied vols are unlikely to see broad-based increases, as they are anchored by even lower realized vols for the front-end tenors. To the contrary, at the 6m-9m tenors, current implieds are around 1 vol below 6m-9m realized vols. History suggests that implied-realized spreads of this size tend to not persist for long. The magnitude of the dislocation suggests implied vols at 6m-9m tenors are now cheap enough to own outright, in our view.

Exhibit 7: 6m EURUSD and GBPUSD straddles are cheap vs historical moves and our forecast
6m USD/G10 straddle pricing vs historical median 6m spot moves and BofA forecasted spot move for the next 6 months



Source: BofA Global Research, Bloomberg

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Exhibit 8: EURUSD implied rises on average by 1.7 vols over the next 6m 87% of the time after falling below 5th percentile
Percentile of 6m EURUSD implied vol relative to history

Source: BofA Global Research, Bloomberg

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Current market pricing favors owning 6m EURUSD straddle

Across USD/G10 pairs, we would prefer to own 6m ATMF straddles in EURUSD and GBPUSD. Current pricing is around 3.2% for EUR and 3.7% for GBP straddles. The prices are low in comparison to both our forecasted move between now to end of 3Q24 (3.6% for EURUSD and 5.4% for GBPUSD) and the typical moves these pairs would historically see over a 6-month horizon (5.1% for EURUSD and 4.2% for GBPUSD).

6m EURUSD implied vol currently sits at the 4th percentile relative to its long-run history. Historically the implied vol would rise over the subsequent 6-months period by an average of +1.7 vols 87% of the time when it fell below 5th percentile (Exhibit 8). The potential increase in implied vol would increase the likelihood for the straddle to become in-the-money. On the back of these views, we enter a 6m ATMF EURUSD straddle for 3.3558% EUR (expiry Oct 7 '24, strike 1.0880, spot ref 1.0804, vol ref 6.019). At expiry, the straddle would break even if spot is above 1.1260 or below 1.0538. The risk would be the continuation of the broadly low vol regime for rest of 2024 as investors' reluctance to make directional FX trades persists.

What if the Fed does not cut in June?

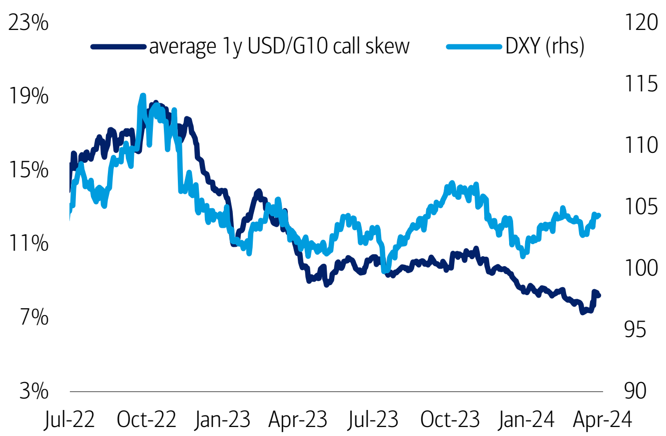
The market pricing for Fed cuts in '24 has pared back substantially since the start of the year. But as it currently stands, the Fed's own dot plot still shows its own median forecast expects 3 rate cuts this year. As a result, the market pricing had not been able to sustainably fall below 3 rate cuts, and our economists also remain of the view that the Fed would likely conduct 3 rate cuts this year in their base case (US Economic Weekly, 5-Apr-2024).

Uncertainty over the Fed rate path for '24 would likely clear up by the June FOMC. As market expectation converges to the same direction, FX volatility would likely pick-up again on the back spot trend formation. In the scenario that Fed chooses not to cut rates in June, we believe long-dated FX option skews would likely materially reprice higher in favor of USD calls.

Long-dated USD/G10 skews are still looking for USD to weaken

Investors have largely been chasing the year-to-date USD rally via short-dated options (see Option Flows section in FX Quant Insight: 18 Mar 2024 and FX Quant Insight: 25 Mar 2024). However, at the 1y tenor, USD/G10 option skews have diverged from spot USD since 2H23 (Exhibit 9). 1y skew has repriced slightly higher for USD calls in the second half of March '24, but still points to a much more bearish USD positioning vs year-to-date USD spot move.

Exhibit 9: 1y USD call skew has room to widen should Fed rate cut expectation for '24 further recede
1y USD call skew vs DXY index



Source: BofA Global Research, Bloomberg

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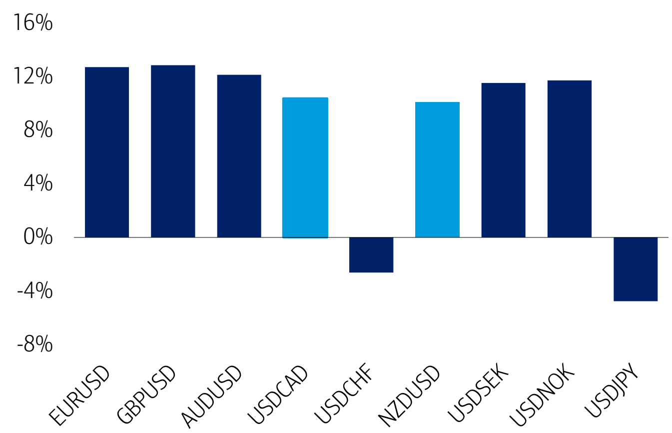
Exhibit 10: 1y USD call skews have the least premium against CAD and NZD
1y USD/G10 call skew



Source: BofA Global Research, Bloomberg

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USD call skews to widen vs CAD & NZD should Fed '24 rate cut pricing recedes

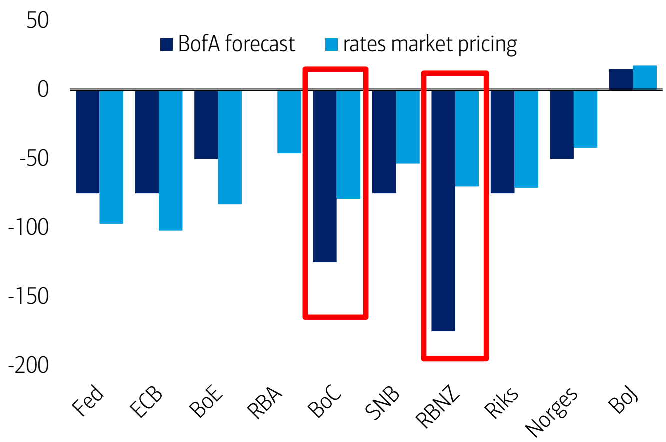
Across USD/G10 pairs where the skew is for USD calls, the 1y tenor shows the least amount of risk premium for the USD against CAD and NZD (Exhibit 10). At the same time, our economists expect the Bank of Canada (BoC) and RBNZ to conduct the most aggressive rate cuts in G10 this year (Exhibit 11).

As our current FX forecasts still incorporate the view that the Fed would conduct monetary policy easing this year, we have both CAD and NZD modestly appreciating vs the USD this year (see Liquid Insight: 28 Mar 2024), although not by nearly as much as the amount of appreciations our forecast has for other G10 currencies.

Should the June FOMC rate cut not materialize, however, the widened monetary policy path between the Fed and BoC/RBNZ would likely lead to more CAD and NZD vulnerability. As a result, 1y FX skews should reprice higher by at least +3% for USD calls against CAD and NZD to reflect the new monetary policy divergences, in our view. The risk would be the Fed cutting policy rate in June as market currently prices.

Exhibit 11: Our economists expect more rate cuts for BoC and RBNZ than market pricing in '24

BofA forecast G10 central bank rate cuts vs market pricing



Source: BofA Global Research, Bloomberg

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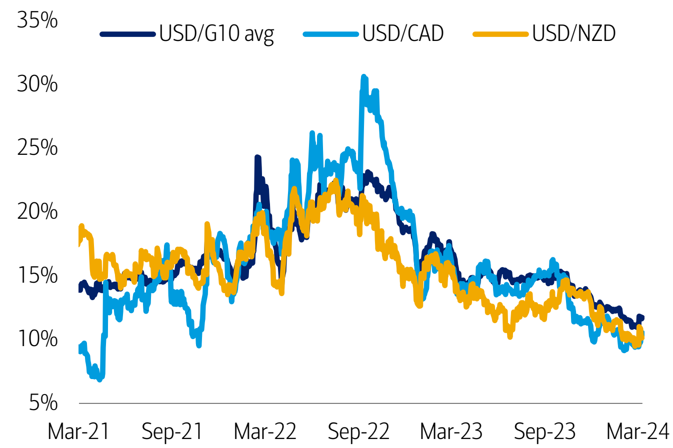
Exhibit 12: 1y USD skew vs CAD and NZD should revert back to Q3 '23 levels should the Fed June rate cut not materialize

1y USD skews, risk reversals as % of ATM



Source: BofA Global Research, Bloomberg

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