FX Viewpoint

How USD bears thrive amid 2024 USD rally

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G10 FX Strategy
Global

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Short OTM USD call strategy so far in 2024

While the USD has grinded higher in spot market this year, the pace has been gradual with only a few days of sharp appreciation. This kind of USD move has allowed passive short OTM (out-of-money) USD call strategies to perform, as USD spot does not rally enough to breach the OTM call strike levels at expiry. So far in 2024, passive short OTM USD call strategy has only had a brief and moderate drawdown in April, on the back of US CPI surprise. As a result of the low year-to-date realized vol for the USD, the strategy has also had higher hit ratio in 2024 than over the past decade. In G10, passive short OTM USD call strategy has had the highest hit ratios against EUR and AUD. The strategy worked less well for USDJPY and USDCHF as the USD exhibited stronger uptrends in these pairs this year. In EM, short OTM USD calls had higher ratio ratios vs ZAR and INR.

Near-term outlook for short OTM USD call strategy

For the next 1-2 months, given benign May US inflation and FOMC guidance, hard landing and Fed tightening risks that could lead to significant USD upsides remain unlikely. Our base case favors continuation of the carry strategies for select short OTM USD call structures, as consensus forecast continues to look for modest USD depreciation. Recent global election surprises increased idiosyncratic risks for some currencies, which calls more disciplined pair selection to the strategy. In G10, we would prefer to short OTM USD calls more against AUD than EUR to avoid the heightened uncertainty around the French election.

Risk picks up in H2 Aug as investors focus on US election

We expect passive short OTM USD call strategy to underperform once market focus shifts to the US election. In 2024, change in realized FX volatility since start of the year is below past election years. However, forward vol premium for the 2024 election is higher than all of the historical election years since 2004. The contrast between the subdued realized vol so far and elevated election risk premium suggests market believes an abrupt vol regime shift would take place later this year before the US election date. We believe the most likely timing for this regime shift is the second half of August. Market attention should shift to the US election theme by then, coinciding with the seasonal pick-up in FX volatility from a summer trough. Risk would be an earlier regime shift as the Presidential debate this year is taking place earlier than in the past. Recent election turmoil outside of the US could also increase FX investors' sensitivity to US election headlines.

DXY: US Dollar Index

SMA: simple moving average

OTM: out-of-money

ATM: at-the-money

ECB: European Central Bank

BoC: Bank of Canada

SNB: Swiss National Bank

Refer to important disclosures on page 8 to 9.
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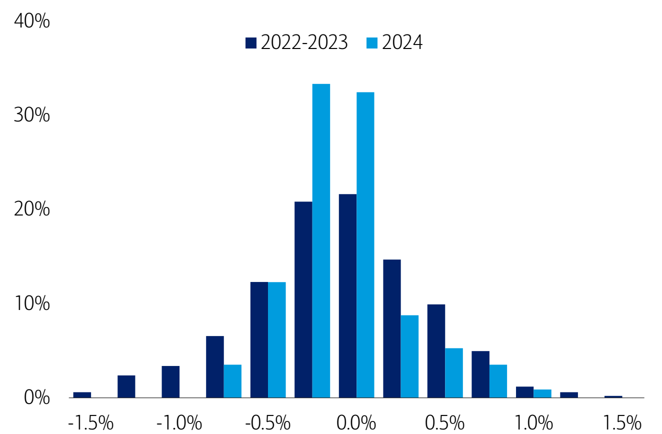
Timestamp: 18 June 2024 01:00AM EDT

How should USD bears react to year-to-date USD rally

With the USD rising so far in 2024, year-to-date FX price actions have been more kind for USD bulls. At the start of the year we thought market consensus bearish USD view was vulnerable to correction (FX Viewpoint: Hedging a potential USD bounce in Q1, 16-Jan-2024). Nevertheless, the USD appreciation has been more of a grind in 2024, unlike the past 2 years (Exhibit 1). The distribution of daily USD returns this year is more centered around 0% with a smaller right tail.

Back in 2023, our mid-year FX outlook at the time discussed shorting OTM USD calls as a way to position for softer USD in the second half of the year (FX Viewpoint: 21 June 2023). Previously, we also looked at the historic performance of passive selling 1-week ATMF USD straddles (FX Viewpoint: Do passive vol strategies work? 8-Feb-2022). So far in 2024, shorting OTM USD calls continue to work well for USD bears despite USD grinding higher in the spot market. In this note, we discuss how shorting OTM USD calls has worked out for USD bears in 2024 and why it is likely to work for select pairs like AUDUSD this summer, in our view.

Exhibit 1: Distribution of daily USD return in 2024 is more centered around 0% with smaller right tail than past 2 years
Distribution of DXY return 2022-2023 vs 2024



Source: BofA Global Research, Bloomberg

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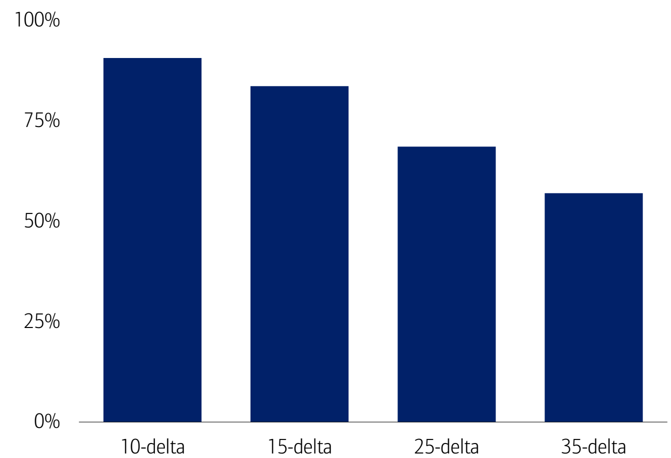
Exhibit 2: Shorting more OTM USD calls has had high hit ratio in 2024
Hit ratio of shorting 2-week OTM USD call at various strike levels in 2024



Source: BofA Global Research, Bloomberg. Hit ratio shows the average performance of shorting OTM USD puts vs EUR, JPY, GBP, CAD, and AUD.

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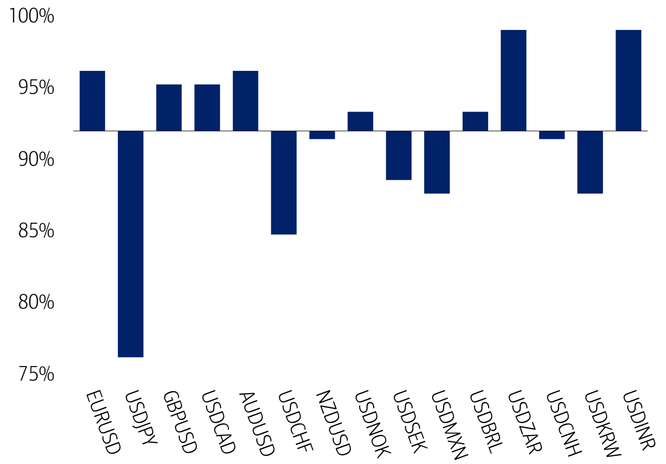
How shorting OTM USD calls fared in 2024

We looked at the hit ratio of occurrences where the spot at expiry did not breach the initial strike levels for USD call sellers. In 2024, passive short 2-week USD calls has had a lot higher hit ratio at OTM strikes levels that were beyond 10-delta (Exhibit 2). Given the USD has appreciated in spot terms, shorting the closer to ATM 35-delta strike only had a hit ratio of 57%. In other words, over two-week periods the USD has rallied above the 35-delta call strike 43% of the time, resulting in negative payoffs for the option-seller in these cases. However, 91% of the time, USD rallies this year were unable to reach the 2-week expiry 10-delta strikes levels against liquid G10 currencies (EUR, JPY, GBP, CAD, and AUD), allowing the option-sellers to retain much of the initial option premiums.

The strategy has averaged a 92% hit ratio among 15 major G10 and EM pairs (Exhibit 3). In G10, shorting 2-week OTM USD calls had the highest hit ratios for EUR and AUD so far this year (Exhibit 3). The strategy worked less well for USDJPY and USDCHF, where the USD has exhibited stronger spot uptrends. In EM, shorting USD calls worked relatively better against ZAR and INR. Nevertheless, shorting 2-week 10-delta OTM USD calls broadly had hit ratios above 80% across all currencies except against the JPY.

Exhibit 3: Passive short OTM USD call worked least well vs JPY and CHF
Hit ratio of shorting 2-week 10d OTM USD call against various currencies in 2024



Source: BofA Global Research, Bloomberg. X-axis crosses at the average 92% hit ratio across all currencies.

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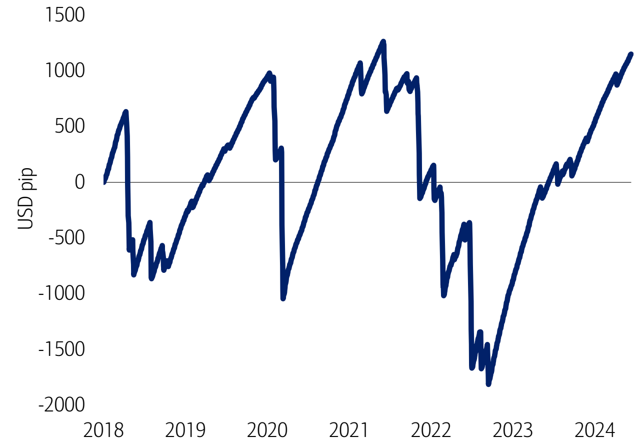
Exhibit 4: Passive short of OTM USD call is exposed to tail risk and sharp drawdowns in the long run
Cumulative return profile of passive short 2-week 10-delta EURUSD put since 2018



Source: BofA Global Research, Bloomberg. Cumulative return is computed as the cumulative pnl in USD pips with option premiums calculated using Black Scholes. Theoretical performance presented is hypothetical in nature. It is not intended to be an indicative of actual or future performance. The actual performance may vary significantly from the theoretical performance.

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Identifying risks to shorting OTM USD calls in a historical context

Passive shorting options inherently tends to show high hit ratios but is prone to material tail risk and large drawdown during sharp USD rallies. This is a form of a carry strategy where rare instances of losses skew larger than common instances of gains and the goal is to get a handle on risks of USD rallying for this strategy. We focus on two broad categories of such risks:

1. Fed tightening with rising US rates supporting structural USD bull runs.
2. Risk-off shocks triggering flights to quality bidding up USD.

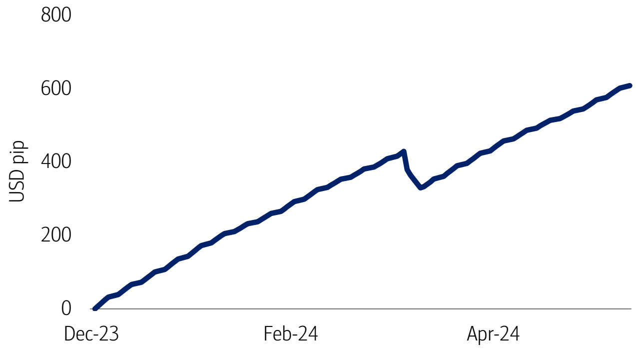
In terms of cumulative return and drawdown, Exhibit 4 shows passive short USD call has been a risky strategy in the long run. In years of FX vol spikes and sharp USD rallies like 2020 (risk off driven) and 2022 (policy tightening driven) the drawdown could fully erase the gains that were built by collecting option premiums over time. A surprise risk-off episode may produce a brief period of sharp drawdown with the strategy able to eventually recover after the risk-off sentiment receded like in 2020. By contrast, Fed tightening-led USD rally tends to generate a more gradual loss profile, but the drawdown could extend for as long as the Fed tightening supported the USD rally in 2022.

USD grind higher has been dominated by falling vols YTD

While the USD has grinded higher in spot market this year, the pace has been gradual with only a few days of sharp appreciation. This kind of USD move has allowed passive short OTM (out-of-money) USD call strategies to perform year-to-date not only from a hit ratio angle but also in terms of cumulative return. So far in 2024, shorting 2-week 10-delta EURUSD puts has only seen a very moderate drawdown in April when the USD gapped higher on the back of hot US CPI inflation surprise (Exhibit 5). For the first five months of the year, this was the only incidence where the pick-up of upward USD realized vol caused a brief drawdown for USD bears who were shorting OTM 10-delta EURUSD calls.

Exhibit 5: But in 2024 passive short of the same option only had one moderate drawdown in April

Cumulative return profile of passive short 2-week 10-delta EURUSD put in 2024



Source: BofA Global Research, Bloomberg. Cumulative return is computed as the cumulative pnl in USD pips with option premiums calculated using Black Scholes. Theoretical performance presented is hypothetical in nature. It is not intended to be an indicative of actual or future performance. The actual performance may vary significantly from the theoretical performance.

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Exhibit 6: Shorting OTM USD calls had higher hit ratio than in in past years except for USDJPY and USDCHF

Hit ratio of shorting 2-week 10d OTM USD calls against liquid G10 currencies by year

	EURUSD	USDJPY	GBPUSD	USDCAD	AUDUSD	USDCHF
2014	85%	84%	87%	91%	90%	91%
2015	87%	95%	88%	83%	87%	90%
2016	89%	84%	86%	96%	91%	90%
2017	99%	89%	96%	89%	97%	94%
2018	88%	92%	90%	92%	87%	89%
2019	93%	95%	90%	98%	90%	92%
2020	93%	94%	92%	91%	90%	95%
2021	85%	85%	95%	92%	91%	86%
2022	86%	79%	86%	92%	90%	83%
2023	92%	87%	96%	91%	91%	95%
2024	96%	75%	95%	94%	95%	85%

Source: BofA Global Research, Bloomberg

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Currency selection matters

We compare different currency expressions of shorting USD calls in 2024 vs in history. Exhibit 6 shows the strategy worked less well for USDJPY and USDCHF as the USD exhibited stronger uptrends in these pairs this year, driven by (1) Fed tightening risk channel. The strategy in other liquid USD pairs has done better where price action had been more range bound, relatively higher hit ratios than in the past decade. In the case of EURUSD, shorting 2-week 10-delta OTM EURUSD put only had higher hit ratio in 2017, a year where the USD broadly weakened against global currencies.

When EUR spot sharply weakened after the snap French election announcement over the June 8-9 weekend, EURUSD spot only knee-jerk fell to 1.0765 on June 10, still above the 1.0727 10-delta strike level for OTM EURUSD put option sellers from two weeks prior. However, as significant near-term political uncertainty remains in France, other (non-EUR) expressions like shorting OTM AUDUSD puts may start to see better performance than short OTM EURUSD put.

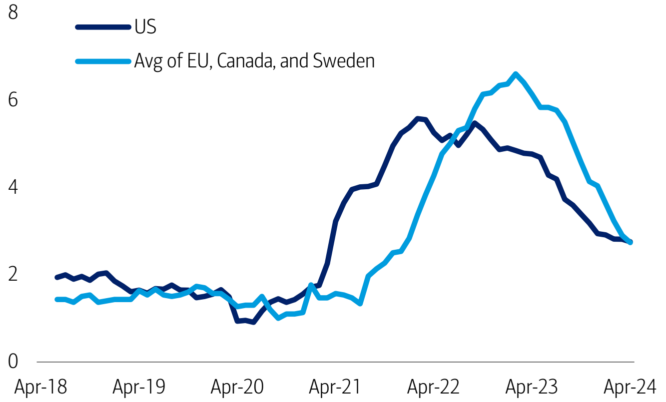
Shorting OTM USD calls in H2 2024

Risk of further Fed tightening is relatively muted

We don't see Fed tightening as a likely risk to carry strategies right now. The US rates market sees reacceleration scenario as only 5-10% likely (US Rates Viewpoint: Range of outcomes and likelihoods, 11-Jun-2024). Fed guidance from the most recent FOMC meeting confirmed the next move is still more likely to be a rate cut than a rate hike (US Watch report dated 12 June 2024). Year-to-date, while US inflation in Q1 '24 had surprised above expectation, the disinflationary path in US has not materially deviated from rest of the world (Exhibit 7). The ECB, Riksbank and BoC were able to start the rate cutting cycle as these regions saw greater disinflationary momentum in more recent months. The SNB has also been able to cut policy rate with Swiss inflation now below 2%.

Given the outlook for more disinflationary trends in the US and latest benign inflation tracking (US Watch report dated 13 June 2024), consensus DXY forecast still looks for moderate USD downside (Exhibit 8). The pace of USD depreciation in consensus forecast is slower than what forwards would imply. The backdrop of a falling USD forecast profile would favor short OTM USD calls structures, which are aligned with our bearish USD and short vol view.

Exhibit 7: US core PCE has decelerated to similar levels as countries that have started rate cuts
US Core PCE YoY vs average of core inflation indices for EU, Canada and Sweden



Source: BofA Global Research, Bloomberg

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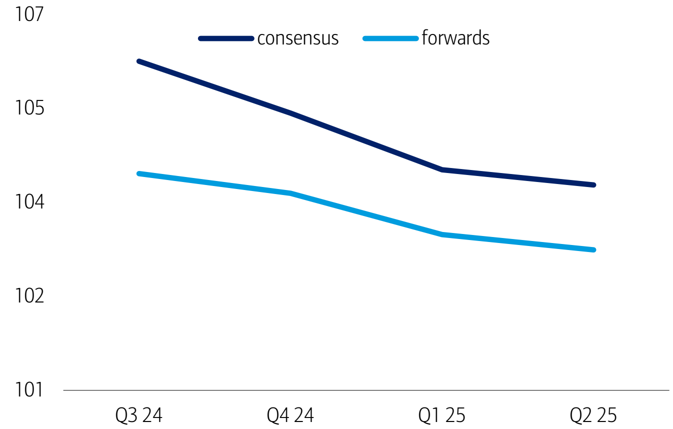
Exhibit 8: Consensus still sees USD depreciation but more moderate than forwards
Consensus DXY forecasts vs forwards



Source: BofA Global Research, Bloomberg

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Risk-off demand for USD is the main risk to carry going forward

Since we don't see (1) Fed tightening as likely, we believe it is (2) the risk-off shocks that pose the main risk to carry strategies going forward, including shorting OTM USD calls. We can further subdivide potential risk-off shocks as follows:

(i) Systematic hard landing shock when USD rallies broadly from "safe haven" demand and

(ii) Idiosyncratic shock where a specific currency weakens against the USD. This includes the near-term French election risk.

Lack of a 'hard landing' evidence for now supports carry regime

In the (i) hard landing scenario, the Fed would cut rates sharply but the US dollar gets a broad bid from so-called "safe haven" flows and vol picks up. The US rates market pricing suggests 10-15% probability of a hard landing (US Rates Viewpoint, 11-Jun-2024), supporting the carry regime for now.

Idiosyncratic risks remain: prefer AUDUSD over EURUSD

At this juncture we see idiosyncratic risk-off shocks as most significant for carry strategies. Just like the Mexican election surprise has hurt long MXN carry positions, we think the French election poses an idiosyncratic risk to EURUSD vol.

Investors who continue to pursue carry strategies should consider currency selection carefully. Our analysis shows short OTM AUDUSD expression is a better expression into this summer. (Global FX weekly: The summer of vol, 14-June 2024).

Secondly, when selling vol we prefer strikes that are sufficiently far from OTM like 10-delta, over 35-delta strikes (Exhibit 2).

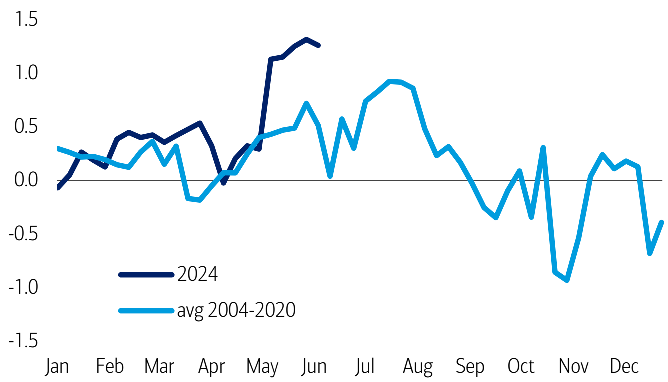
Market sees FX vol regime shift closer to US election

The short USD call strategy should start to underperform once market attention shifts to the upcoming US election. The risk to short OTM USD call structures materially increases by the second half of August after the Democratic National Convention as the headlines become more focused on the general election phase of the campaign, in our view.

Given 2024 US election is less than 6 months away from now, we would use the 3m3m forward vol – 3m implied vol spread as a gauge for the current market pricing of election risk premium. Exhibit 9 and Exhibit 10 show FX market is pricing more US election premium in 2024 than all of the recent election years since 2004. The 3m3m EURUSD forward vol saw a larger jump at the start of May this year (as it started to cover the November US election date) than historical election year average (Exhibit 9). Current 3m3m EURUSD forward vol – 3m implied vol spread is also larger than all of the recent US election years (Exhibit 10). EURUSD may also be volatile into July around the French election.

As we noted in the 2024 Year Ahead outlook (FX Viewpoint report dated 21 November 2023), the market tends to enter US election years with a bullish vol bias. However, year-to-date, the CVIX index has been more subdued than historical election years (Exhibit 11). The contrast between how FX vol has behaved so far this year and current elevated market pricing for FX vol around the US election would suggest market believes an abrupt FX vol regime shift is likely to happen at some point. As for now, we see the most likely timing as the Democratic National Convention, which also coincides with the seasonal pick-up for FX vol around second half of August (Exhibit 12). The risk would be market attention shifts to US election earlier and short OTM USD call strategies becoming more short-lived than we expect, given Presidential debate has been pushed to earlier this year than in the past. Recent election turmoil outside of the US may also raise market's sensitivity to US election headlines.

Exhibit 9: Market currently prices in 1 vol risk premium for 2024 election
2024 3m3m EURUSD forward vol – 3m implied vol spread vs historical election years



Source: BofA Global Research, Bloomberg. The light blue line shows the evolution of 3m3m EURUSD forward vol – 3m implied vol spread for 2004, 2008, 2012, 2016, and 2020.
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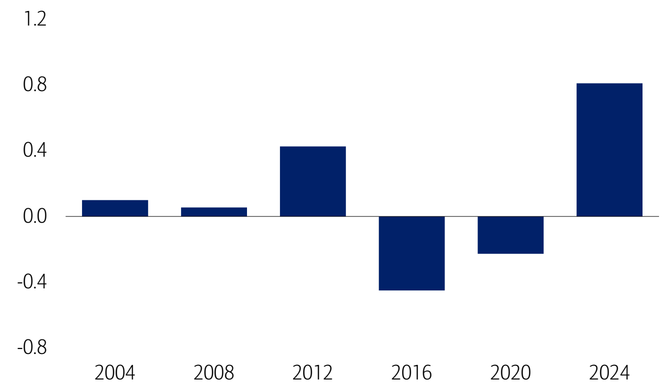
Exhibit 10: FX vol market prices more election premium for 2024 than recent election years
3m3m EURUSD forward vol – 3m implied vol spreads at mid-June in election years



Source: BofA Global Research, Bloomberg
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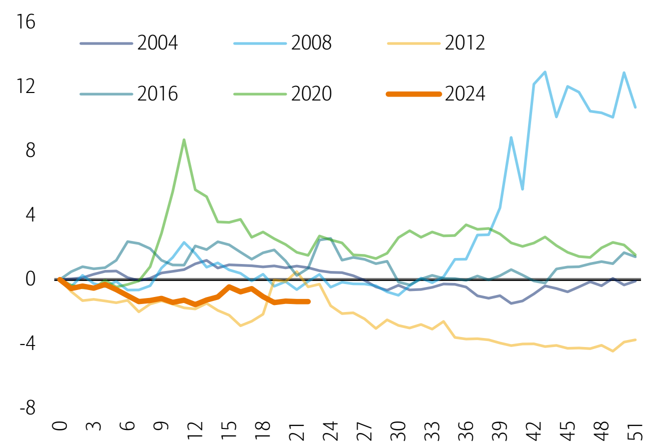
Exhibit 11: Level of FX vol year-to-date is low vs past election years
CVIX index in election years (normalized to start of each year)



Source: BofA Global Research, Bloomberg
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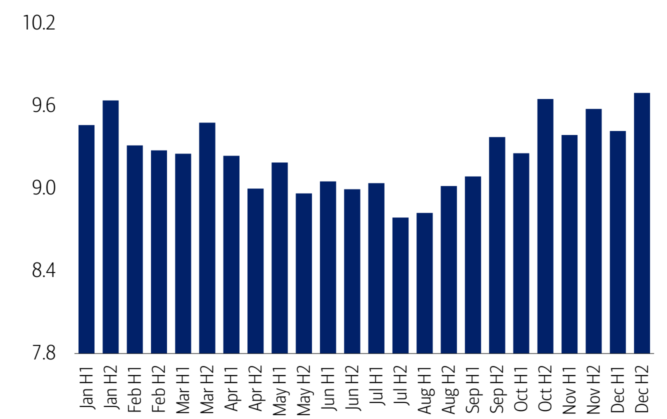
Exhibit 12: FX vol seasonally bottoms out around second half of July and first half of August
Bi-monthly FX vol seasonality since 2004



Source: BofA Global Research, Bloomberg
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