MACRO STRATEGIST

GLOBAL EDITION

January 16, 2025

ONE CURRENCY TO RULE THEM ALL

Key macro themes

The all mighty dollar – **The US dollar had a very strong 2024**, appreciating against almost every other currency in the world. USD appreciation primarily reflects hawkish Fed policy expectations, with investors pricing in less rate cuts than by other major central banks (F1). America's large growth premium and political instability in Europe amplified gains.

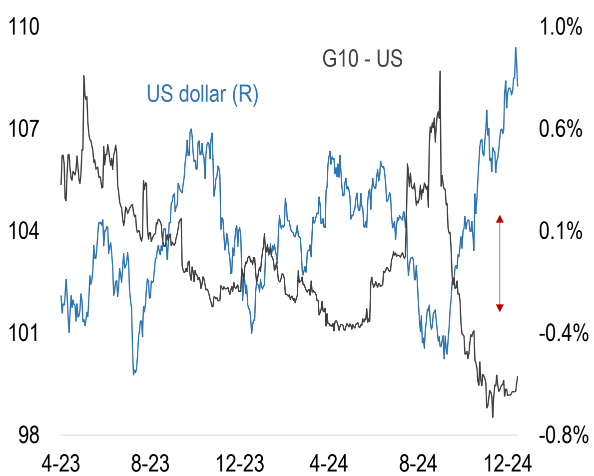
A huge call – Few macro calls are as important in setting portfolio strategy as the dollar view, as this greatly affects the risk-reward profile of international assets (F2). Investors expect the greenback to weaken against most other DM currencies this year. Yet this is far from a trusty signal, as **markets are particularly bad at anticipating FX swings**.

Investment strategy

Risks contained – Standard macro models also point to a USD reversal, but ignore the political environment. Incoming tariffs and potential retaliation would exert upward pressure on the dollar. Merging these signals (historically the right move in terms of prediction), dollar **appreciation remains the most likely outcome, but a large jump is less likely than in H2/24**.

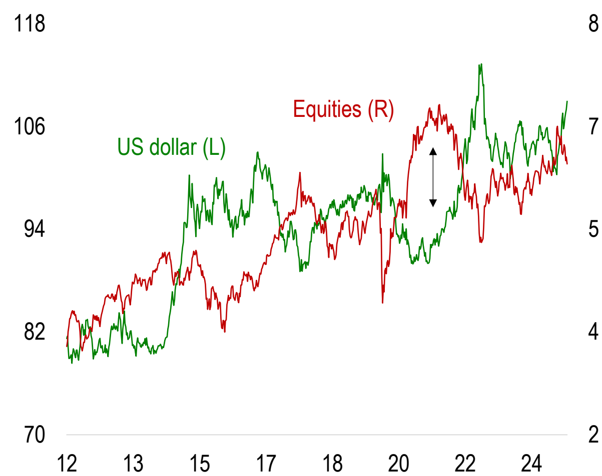
Charts of the month

F1: Hawkish Fed views are fueling dollar
US dollar vs. expected G10-US rate spread



Note: Chart plots the US dollar index (USDX) against the 6-month expected policy rate differential between G7 central banks and the Fed. Rate spread is USDX currency weighted. Source: ICE, Numera Analytics.

F2: USD outlook is crucial for positioning
US dollar index vs. global (ex. US) equities



Note: Chart plots the US dollar index vs. the MSCI ACWI ex. USA index. We show the equal-weighted version to eliminate our country bias. Source: ICE, MSCI.

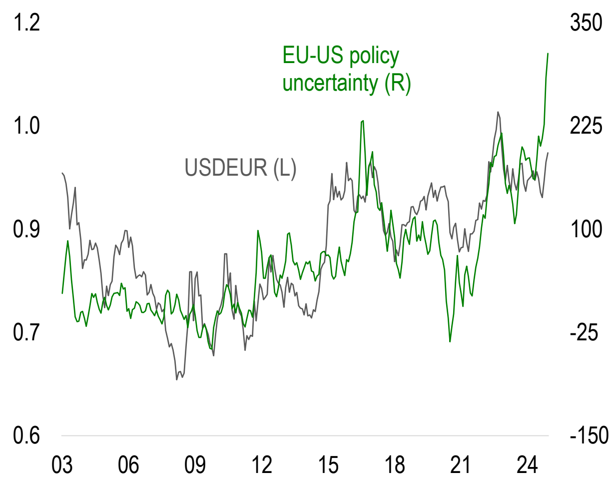
In this section:

- What lies behind current dollar strength? (p. 2–3)
- Will the dollar continue gaining ground? (p. 3–4)

King dollar – The US dollar had an impressive run last year, rallying 8% against other reserve currencies, and even more so versus EM trading partners. The breadth of the improvement is more impressive, with the greenback gaining ground against 37 of the world's 40 most liquid currencies. The strong dollar is having profound market implications, greatly favouring US over offshore assets, weighing on commodities, and increasing international funding costs.

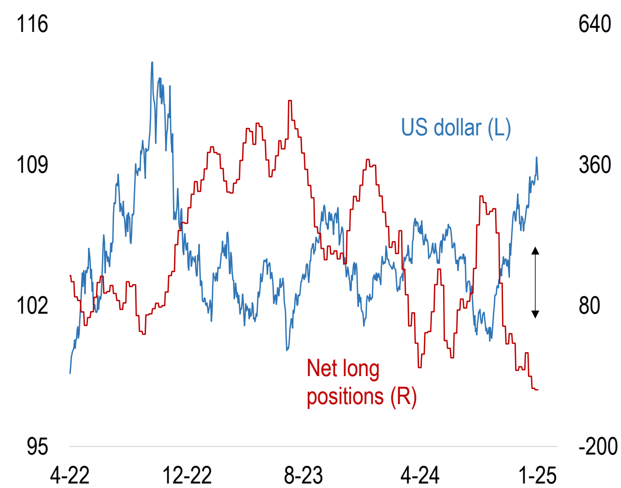
What is behind current dollar strength? The most important factor is a major **disconnect in policy expectations between the Fed and other central banks** (F1). In particular, while market participants are pricing in 'higher-for-longer' Fed policy, they expect other monetary authorities (the ECB in particular) to cut faster and by a greater extent.

F3: Uncertain global context favours USD
USDEUR vs. EU-US policy uncertainty



Note: The green line measures the spread between the EU and US news-based economic policy uncertainty indices. Source: Macrobond, Baker, Bloom and Davis.

F4: Speculation has amplified dollar gains
USDX vs. net long positions on DM currencies



Note: Chart plots the USDX against net long positions by asset managers on DM currencies (EUR, JPY, GBP, CAD and CHF). Source: ICE, CFTC.

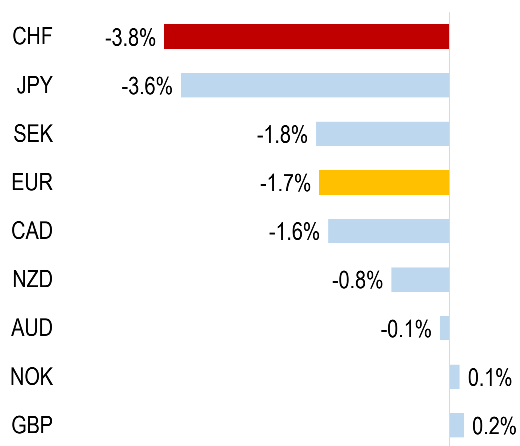
One reason for this are stark differences in economic strength. Unlike other DMs, spending in the US is proving remarkably resilient to a high rate environment. Not only does this lift the USD via rate expectations, but also lifts the USD directly **by encouraging capital inflows into the US** as investors seek to benefit from this growth premium.

Another important driver behind broad dollar strength has been significant policy uncertainty in Europe. The tradeable dollar index (USDX) depends primarily on USDEUR fluctuations, so economic or political developments in the EZ have an outsized impact on dollar moves. As we can see in F3, political crises and subdued activity have made for **a much more uncertain environment in Europe than in the US**, in turn contributing to dollar strength.

Besides their fundamental impact, these factors also boosted the dollar via speculation. We can see this in F4, which plots the USDX against net long investment positions on G10 FX futures. In almost every case, **short selling has pushed the dollar above 'fair' value**. As we argued earlier this month, this is particularly evident with the USDJPY pair, which is again approaching 160 when US-JP yield spreads imply a nominal exchange rate closer to 140.

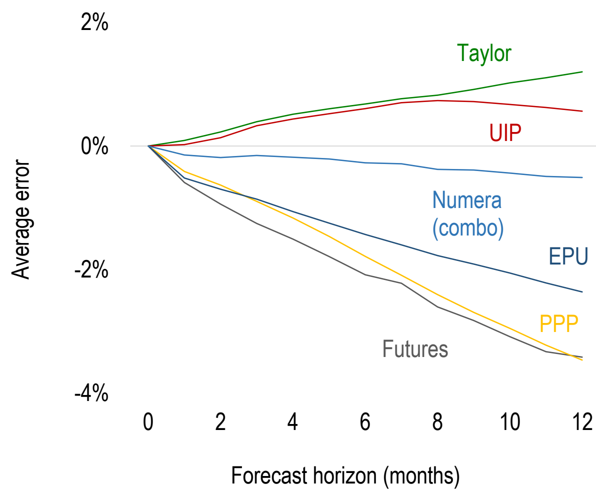
The hardest guess – The dollar outlook matters immensely for positioning, both as a risk-on / risk-off signal, and in assessing the appeal of international diversification. **So will the dollar keep strengthening in 2025?** A simple starting point is by looking at currency futures for guidance. F5 shows market expectations for all DM currencies. With a few exceptions, investors anticipate a partial reversal, with a 1.7% expected drop in the USDEUR pair.

F5: Investors are pricing a partial reversal
USD vs. DM currency expectations - 12/25



Note: Expected change in the USD versus individual DM currencies by Dec. 2025, as priced in by futures markets. Source: CME; Numera calculations.

F6: Yet market views are no gold standard
USDEUR forecast evaluation - Model bias



Note: Chart compares the average prediction error at forecasting the USDEUR across model specifications since 2014. Positive values indicate expectations exceed realizations (overshooting). Source: Numera Analytics.

However, this signal is of limited use, since **investors typically struggle at predicting FX movements**. T1 compares the forecasting performance of G10 FX futures over the past decade. The first row compares the average margin of error of one-year quarterly contracts, while the second line compares these to a simple 'no change' forecast. Finally, the last row shows how often markets at least guess directional movements at a 12M horizon.

In terms of accuracy, **USDCAD futures are the only ones with slight predictive ability**. In the case of the yen, for instance, the average miss was 9% higher than if investors had assumed no future variation. Even gauging the direction is a struggle: Over the past decade, markets only got this right for the USDEUR less than 40% of the time.

In the case of the EUR and JPY, markets also have a large **negative bias, underestimating the extent of dollar gains**. F5 shows this for the euro, tracking the average prediction error by forecast horizon for USDEUR futures and various model specifications. In the case of futures (the dark grey line), markets undershoot by over 3% 12M out.

T1: Market FX predictions 12M forecast evaluation	EUR	CAD	GBP	JPY	CHF
Prediction errors	*7.1%*	*6.4%*	*7.7%*	*8.8%*	*6.1%*
Accuracy gain / loss	*-5.1%*	*1.5%*	*-3.4%*	*-9.0%*	*-2.5%*
Directional accuracy	*39%*	*58%*	*57%*	*46%*	*53%*

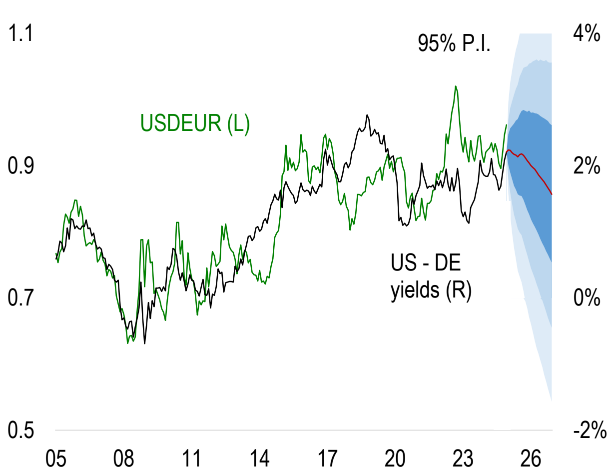
Note: Forecasting performance of futures markets at anticipating currency movements over the past decade. The rows show mean absolute prediction errors, the average accuracy gain or loss versus a 'no change' forecast, and the mean directional accuracy. Source: Numera Analytics.

Notice, however, that forecast models also struggle. This brings us to a more general problem, known as the 'exchange rate predictability puzzle' in academia: Because FX is very forward looking, spot rates are especially adept at fully pricing the macro outlook, making it extremely difficult to beat simple 'no change' forecasts.

This is problematic for investors, both in consistently generating alpha from FX trades and in properly assessing currency risks in a multi-asset setting. Because of its importance, we have spent time evaluating a variety of competing drivers and models to find a useful toolkit. We find that very complex models with multiple inputs work poorly, and that individual signals alone rarely outperform, but combining models for single signals is an effective approach.

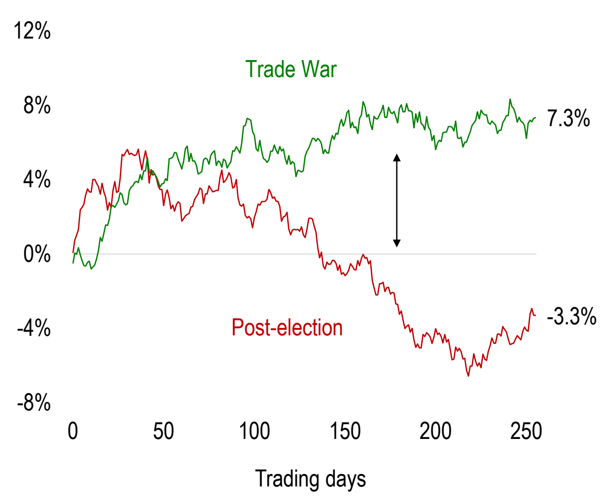
This is exactly what we show in F6. The other lines show the bias in individual models for interest spreads (UIP), pricing arbitrage (PPP), expected policy rates and inflation (Taylor), and economic and trade policy uncertainty (EPU). On their own, each of these models over or undershoot, and are not especially accurate. Yet, the model combination is unbiased and yields powerful results, **boasting accuracy gains of almost 20% versus market expectations**.

F7: Narrower spreads *should* contain USD
USDEUR vs. US - DE yield outlook



Note: Chart plots USDEUR against historical and projected spread between 10Y US and DE sovereign yields. Fan chart denotes 50 / 80 / 95% prediction intervals. Source: History: Macrobond; Forecast: Numera Analytics.

F8: But risk of trade war distorts picture
US dollar during 2016/20 Trump presidency

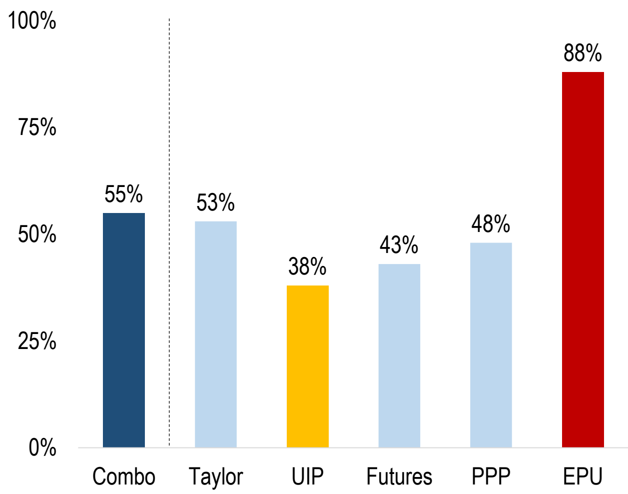


Note: US dollar change in the year after the 2016 election and during the CN / US Trade War (start date set to China's initial retaliation on April 2018). Source: ICE.

So what is this framework signaling today? In line with futures, the **classic UIP and PPP models point to a weaker dollar in 2025**. For interest spreads, this reflects a high probability that the Fed will cut rates by more than markets currently anticipate, likely narrowing US-EZ yield spreads (F7). Since US goods prices have risen more than in the Euro area, purchasing power parity implies USD depreciation as consumers favor EZ-made products.

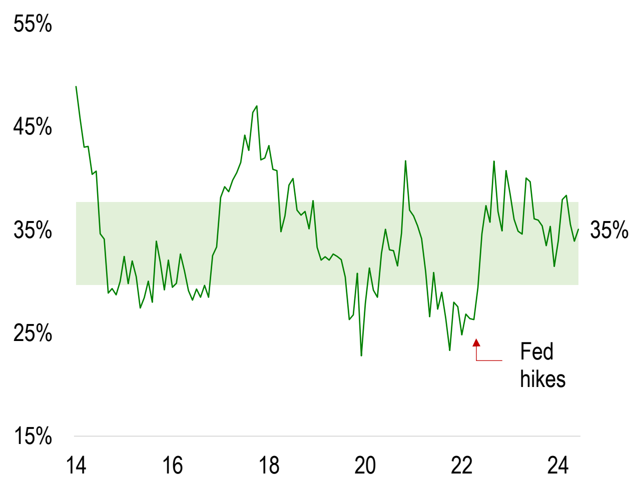
However, this does not factor in the political climate. The EPU model accounts for these effects using the news-based index shown in F3 and a similar one for US trade policy uncertainty. Trump's global tariff proposal has pushed the latter to an all-time high, often associated with large USD gains—especially if Trump follows through on the threat and other countries retaliate (as during the 2018/19 China-US Trade War; F8 above).

F9: Outlook carries significant uncertainty
USD appreciation probability by model - 2025



Note: Bars compare probability that the USD strengthens against the EUR in 2025, across model specifications. Post-GFC average is 61%. Source: Numera Analytics.

F10: Still, moderate risk of lengthy bull run
Likelihood of 5%+ USDEUR appreciation



Note: Chart tracks the likelihood that the USD appreciates more than 5% against the EUR over the following 12M. Results based on a model combination approach, combining signals from 5 sub-models. Source: Numera Analytics.

F9 compares the likelihood of further USD gains across specifications. The interest spread model is the most bearish, showing only a 38% chance of USD appreciation against the EUR, below the historical average. Conversely, the EPU framework suggests double-digit gains, with nearly a 90% probability of a stronger dollar in 2025.

Taken together, this disconnect makes for **a large dispersion in the range of potential outcomes**. In probability, however, the likelihood of further USD gains from the combined model is 55%, 6-points lower than the post-GFC average. Importantly, the chance of a large dollar jump is not high by historical standards. For example, 5%+ gains have a one-in-three chance of materializing, well within their normal range and lower than a few months back (F10).

Across the G10, **downside risks to the dollar are highest versus the yen**, which is trading at a hefty discount. The USDJPY pair is less sensitive to trade uncertainty than other currencies, since the yen is itself a 'safe haven' asset. This increases the importance of yield spreads, which should benefit from BOJ policy normalization.

1. Strategic Asset Allocation

Overweight	Neutral	Underweight
🟢	🟡	🔴

Strategic allocation Positioning by asset	Asset allocation[1]	Country rotation[2]	Key macro factors
DM stocks	🔴	-	Currently neutral, but reduce exposure as US growth slows
United States	🔴	🟡	Tech trading at a premium; risk of pullback as growth slows
DM ex. US	🔴	🟡	Likely pick-up in growth, stable USD, low financial stress
Australia	-	🟢	Terms of trade + AUD upside, responsive to CN stimulus
Canada	-	🟢	BOC cuts support valuations, likely bounce back in oil prices
Europe	-	🔴	Remain UW since other offshore marketsh have higher upside
Eurozone	-	🟡	Upgrade on signs of improving domestic demand, EUR upside
Switzerland	-	🔴	CHF trading at a premium, which curbs overall risk-reward
United Kingdom	-	🟡	Attractive valuations, improving activity, share buybacks
Japan	-	🟢	Improving domestic activity, likely strengthening of JPY
EM equities	🟢	-	Fed easing, weaker USD, low US growth beta, CN stimulus
EM Asia	-	🟡	We are neutral, but cross-country diversification encouraged
China	-	🔴	CN no longer trades at a discount; growth challenges remain
India	-	🟢	Growth premium + business dynamism, but expensive
South Korea	-	🟢	Corporate Value-Up program increases re-rating chances
Taiwan	-	🔴	Similar risk profile to Korea, but overstretched valuations
EM EMEA	-	🟢	Oil prices retain upside, low financial stress, USD to weaken
Latin America	-	🟢	Attractive valuations, commodity upside as Fed pivots
Brazil	-	🟢	Low valuations, further BCB easing, resilient BR economy
Mexico	-	🟢	Reduced MXN risk, valuation upside from Banxico cuts
DM bonds	🟢		Gradually increase exposure as G10 easing cycle continues
United States	🟢	-	Treasury yields should fall in 2025 as growth decelerates
DM ex. US	🟡	-	Neutral as market overestimating ECB easing cycle
EM bonds	🟢	-	Wider EM-DM growth premium, low global financial stress

1. Positioning relative to 60/40 global benchmark. See our *Global Asset Allocation report* for suggested portfolio weights and analysis.

2. OW/N/UW relative to DM and EM equity benchmarks. Positioning depends on projected risk-reward balance of individual equity markets.

2. Top Conviction Calls & Scorecard:

GLOBAL INVESTMENT IDEAS Top Conviction Calls	Action	Open date	Recently closed	Trailing stop-loss[1]	P&L	Report
AU / DM ex. US stocks	OW	27-Nov-23	31-Dec-24	2.8%	2.8%	PDF
EM high yield bonds	Long	28-May-24	19-Dec-24	9.0%	9.0%	PDF
BRL / USD (w. carry)	Long BRL	15-Oct-24	27-Dec-24	-8.0%	-8.0%	PDF
Chile stocks	Long	24-Oct-24	3-Jan-25	-7.0%	-7.0%	PDF
AUD / GBP	Long AUD	4-Nov-24	-	-4.5%	-1.0%	PDF
Mexico stocks	Short	4-Nov-24	-	-6.0%	4.5%	PDF
US / EM stocks	OW	6-Nov-24	-	3.9%	7.2%	PDF
Germany stocks	UW	13-Nov-24	-	-6.0%	-3.8%	PDF
UK bonds	Long	18-Nov-24	-	-9.0%	-5.1%	PDF
CA bonds	Long	20-Nov-24	-	-8.0%	-2.0%	PDF
CORRA futures	Call option	26-Nov-24	20-Dec-24	20%	21.4%	PDF
Henry Hub futures	Put option	5-Dec-24	20-Dec-24	-60%	-60%	PDF
EM stocks	Long	8-Jan-25	-	-9.0%	-0.4%	PDF
Japanese yen	Long	8-Jan-25	-	-6.3%	0.3%	PDF

1. Stop-loss threshold matches the expected loss over the remaining holding period, relative to the current P&L.

Benchmarks:

- **Stocks**: United States: S&P 500 TR; Offshore: MSCI World excl. USA index and country breakdown; EM: MSCI emerging markets USD index and country breakdown.
- **Bonds**: United States: ICE BofAML US Treasury TR (all maturities); DM ex. US: ICE BofAML Global Government excl. US TR USD (all maturities); EM bonds: ICE BofAML EM external sovereign index TR USD.