CURRENCIES: US DOLLAR

ENTERING EXTREME TERRITORY

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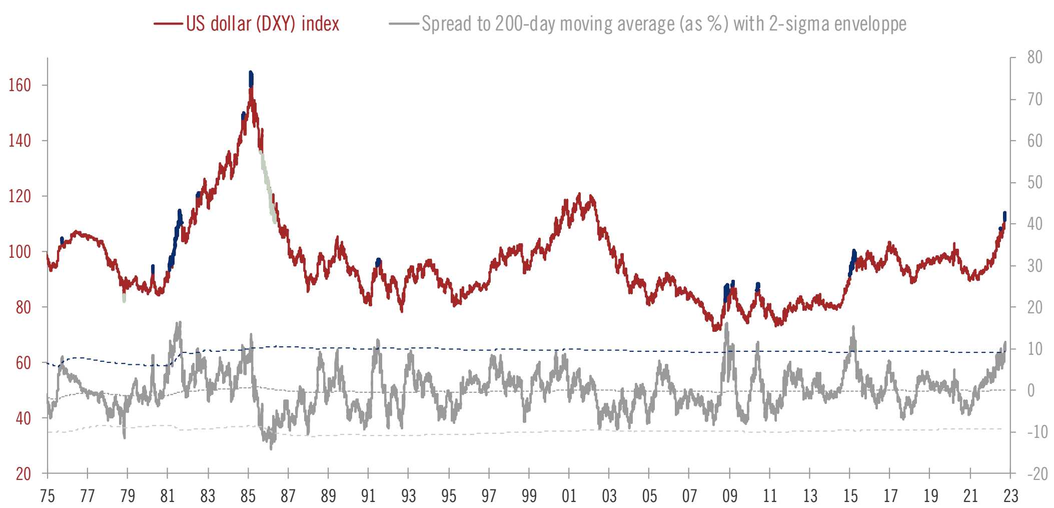
SUMMARY

- The US dollar has gone from strength to strength in recent months, hitting multi-year highs against some major currencies.
- Current drivers of this strength, namely the tightening of financial conditions by the Fed and weak global risk appetite, may endure for a short while, providing little relief to other major currencies such as the euro and renminbi.
- Given the scope for further USD strength in the short term, we have decided to lower our three-month projections on the EUR/USD rate from USD0.97 to USD0.95. Our 12-month projection of USD1.07 is left unchanged.

Pace of USD appreciation has accelerated recently

There has been continued strengthening of the USD in recent weeks, to the point where it looks overstretched from a historical perspective. The combination of a resilient domestic economy and the Fed's aggressive monetary stance have been particularly supportive of the US dollar. Furthermore, the tightening of financial conditions engineered by the Fed is weighing on risky assets, favouring demand for the safe-haven and high-yielding dollar instead. As long as US inflation stays uncomfortably high and the job market remains tight, the Fed may continue to err on the hawkish side, which may keep the greenback strong. One could also assume that severe concerns about US financial stability might make the Fed blink, but these same concerns could first support a strong US dollar.

USD INDEX AND ITS DEVIATION FROM THE 200-DAY MOVING AVERAGE



Source: Pictet WM CIO Office & Macro Research Refinitiv, 3 October 2022

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Short-term outlook for the US dollar remains positive

While a Fed pivot to a less aggressive stance would go a long way to reducing upward pressure on the dollar, one also has to consider that there has been a deterioration in the domestic drivers of rival currencies, pushing them down and adding to the upward pressure on the dollar. A change on this front may be needed to force the US dollar lower in any meaningful way.

In the past, undue dollar strength has led to coordinated forex intervention by central banks. While it cannot be excluded if the dollar continues to strengthen, a repeat looks unlikely in the next few months given that persistently high domestic inflation limits the US authorities' appetite for intervention. We may need to see a sharp decline in US inflation or a big deterioration in liquidity in the FX market before internationally coordinated currency intervention moves up the agenda.

Yen and renminbi hurt by monetary policy divergence

Interest-rate differentials are a key factor in currency movements. The currencies of countries where low inflation means central banks are dovish have lost a lot of ground. Indeed, the sharp decline of the yen has led Japan's Ministry of Finance to intervene to prop up the currency. But with the Bank of Japan (BoJ) still effectively capping long-term yields around zero under its yield-curve-control strategy, we think unilateral forex intervention of this sort will have a limited impact in an environment of upward pressure on yields globally.

In China, the renminbi has also been hurt by a deteriorating interest-rate differential over the US, as the People's Bank of China (PBoC) has been engaged in targeted monetary easing. In the past few weeks, the Chinese central bank has been trying to relieve downward pressure on the currency against the dollar through tweaking the daily renminbi fixing rate and adjusting banks' reserve requirement in FX forward operations as well as through verbal intervention. While those actions should increase the renminbi's resilience to any further dollar strength, we doubt the PBoC will draw a line in the sand for the USD/CNY rate, especially as the Chinese currency remains broadly stable against a basket of currencies.

There are potential catalysts for a revival of both the yen and renminbi. Rising inflationary pressure and the full reopening of the country in the coming weeks could pave the way for a revamp of the BoJ's monetary strategy next April when governor Haruhiko Kuroda steps down. A change in the country's strict zero-covid policy (which is dampening economic activity) could also reduce concerns over the economic outlook in China. While we do not expect any change in the next few months, there could be a reassessment during the National People's Congress in March, especially if it is preceded by prior evidence of increased medical preparations.

High energy costs remain a hurdle for euro and sterling

But even in countries where central banks are hiking rates, currencies are at the mercy of economies' vulnerability to tightening financial conditions. The sharp rise in yields caused by the UK government's announcement of unfunded tax cuts have pushed long-term gilt yields higher in recent days, to the point of threatening financial stability. The recent intervention of the Bank of England (BoE) in the bond market will likely put a lid on upward pressure in the long-end of the curve. But we do not expect the BoE to be able to meet current high market expectations for policy rates (the market was pricing in a terminal rate of over 5.75% on 30 September, compared to the current bank rate of 2.25%). As a consequence, market concerns about ever-increasing external financing needs may continue to weigh on sterling to keep gilts attractive to foreign investors.

Like sterling, the euro has been hurt by a stagflationary shock that has been exacerbated by the war in Ukraine. While unexpected European Central Bank hawkishness has managed to provide some support to the single currency, the euro area economy remains exposed to high energy prices and rising yields. The euro could find some further relief if, as a recent OECD report asserts, the euro area manages to get through the winter without further energy shocks. But it still remains to be seen how high energy import costs will impact economic activity beyond this winter.

Higher yields in the euro area could also have unintended consequences. In particular, rising interest costs will be a challenge for highly indebted countries like Italy. While the ECB's new Transmission Protection Instrument (TPI) should provide a credible backstop, this new tool is only likely to be activated in response to severe financial stress, meaning that the euro may first have to weaken more.

Adjusting our short-term forecasts for the US dollar higher

Overall, while we acknowledge that the US dollar is extremely expensive, and while we see catalysts (notably a pause in the Fed's tightening cycle) for a decline in the US dollar's value at some stage, over the next two months we see limited indication of significant US dollar weakness. While the EUR/USD rate has recently hovered around our USD0.97 three-month forecast, it may be too soon for investors with a very short-term time horizon to sell the greenback. We have thus decided to set our new three-month projections at USD0.95 to take account of further possible short-term strength in the US dollar. However, we are sticking to our 12-month projection of USD1.07. We will adjust our projections for other dollar crosses following the same rationale.

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