Sucden Financial

FX Monthly Report– Dollar

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FX Monthly Report

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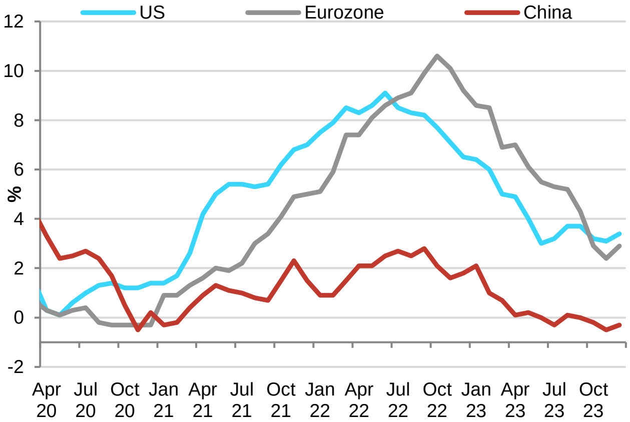
Dollar Focus

The dollar fluctuated in recent weeks, with upward pressures building recently driven largely by changes in the Federal Reserve monetary policy narrative. While the case for another hike has been fully priced out, the market began to question the timing and the scale of the subsequent cutting cycle. Policymakers remain committed to a higher-for-longer narrative, yet uncertainty surrounding the inflationary path and the overall economic outlook is increasingly influencing market sentiment. The dollar responded to these changes as a result. As we head into the year of easing monetary policy across the world, what is our outlook for the greenback in the coming months?

CPI YoY Across Major Economies

Inflation is set to continue to soften in 2024, despite the most recent uptick.

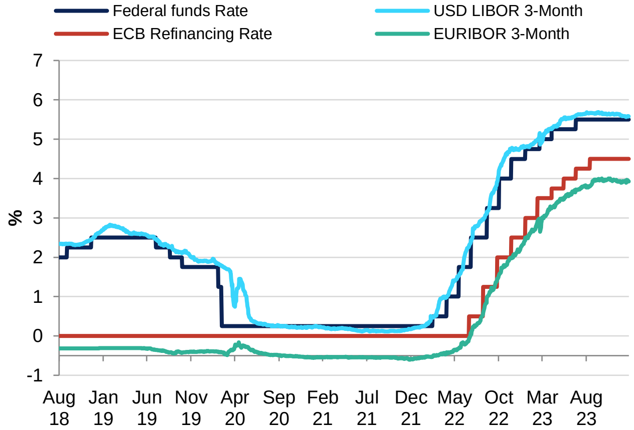


Source: Bureau of Labour Statistics, Eurostat, National Bureau of Statistics

Compared to expectations this time last year, the outlook for the world's largest economy in Q1'24 remains positive, showing no signs of the recession that was once a topic of concern. Robust output growth continues despite certain sectors of the economy, particularly real estate, feeling the pinch from the elevated interest rates. The Q3'23 GDP figure came out at 4.9% YoY, marking the biggest rise in 2 years, leading economists to lift the forecasts for 2023 GDP growth to 2.4% YoY. These relatively high numbers can be attributed to strong consumer spending, which continues to be supported by a resilient labour market. In December, retail sales, a key indicator of consumer spending, outperformed expectations, registering a 0.6% MoM increase. While an uptick was expected in the holiday season, it was higher than the predicted 0.4%, indicating a level of optimism about the personal financial situation despite elevated borrowing costs. Indeed, the recent data points to increased consumer confidence, with the Uni of Michigan Sentiment Index for January rising to 78.8, compared to the previous month's 69.7, underscoring the resilience of the US consumer. The unemployment rate is hovering near a 50-year low, with the recent reading at 3.7% YoY in December, demonstrating ongoing strong job creation bolstered by an increase in the labour force. Weekly jobless claims continue to fall short of expectations while nonfarm payrolls remain higher than the pre-pandemic norm, suggesting that overall economic growth is likely to maintain a steady pace without significant downturns in the coming quarter.

Developed Economies Interest Rates

Most major central banks have ended their tightening cycle last year.

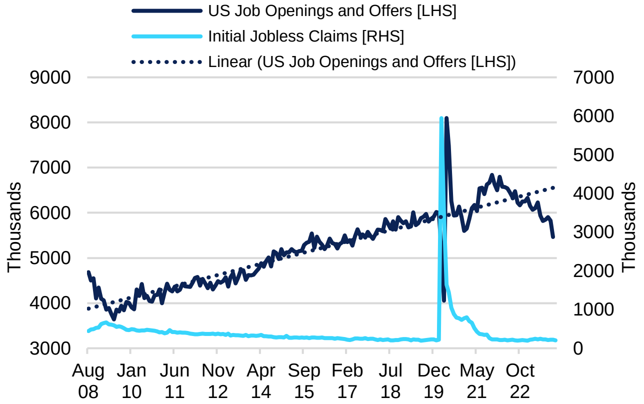


Source: Bloomberg

While inflation has softened significantly from the highs seen in 2022, the persistent tightness in the labour and consumer markets is expected to pose challenges in reducing the rate closer to the target of 2% in the coming quarter. The headline Consumer Price Index (CPI) accelerated to 3.4% YoY in December from 3.1% YoY in the previous month, suggesting that underlying price pressures persist. In our view, inflation softness will continue to be the main trend of 2024, although month-on-month fluctuations are set to be upwardly sticky, creating a bumpy path for the markets trying to gauge the start of monetary policy change. Additionally, ongoing conflict in the Middle East and fears of supply chain disruptions have created potential upside inflationary pressures, necessitating a careful evaluation of monetary policy measures. Geopolitical tensions in the Red Sea led major shipping companies to redirect cargo vessels to the Cape of Good Hope, raising shipping charges by 75%, which is likely to filter down to consumers. While further escalation of the conflict might not immediately translate into higher commodity prices, longer-term effects could have an additional upside for headline inflation print. Overall, the US economy will likely remain resilient in the coming quarter with solid consumer spending and a robust, albeit moderating labour market. We expect inflation to hover around the 3% level while the central bank continues to monitor economic data to determine the appropriate timing of the first interest rate cut.

US Job Openings and Offers vs Initial Jobless Claims

While job openings are falling below the longer-term average, the impact on unemployment remains limited.

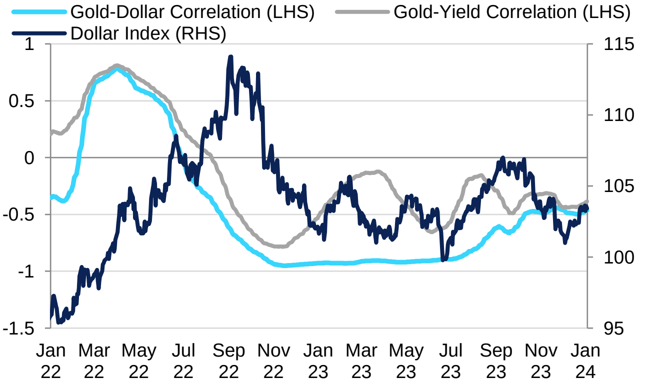


Source: Bureau of Labour Statistics, Department of Labour

Given the combination of strong economic performance coupled with continued discounting in regard to the monetary cutting cycle, we expect the dollar to remain elevated in the coming months. With price pressures persisting, investors' expectations regarding the initiation of monetary easing have significantly shifted since the beginning of the year. On the last day of December 2023, forward swaps were pricing in a 90% probability of a rate cut in March, whereas at the time of writing, it has fallen to 50%. Given the robust economy, the Federal Reserve does not need to rush into implementing monetary policy easing before they are certain price stability has been achieved. Stronger economic performance also puts the US in a much better position to take the hit of elevated interest rates without falling into a recession. Although at the beginning of January, markets anticipated the first cut to materialize in March, we now believe that interest rates will remain elevated for longer, and the first cuts may not take place until June. Until then, we expect a "data-dependent" narrative from the policymakers, aiming to prevent premature expectations of rate cuts from excessively lowering Treasury yields. With the US government's cost of borrowing and mortgage rates at elevated levels, market dynamics are effectively aiding the Fed's efforts, reducing the need for further rate increases. In the meantime, this should ensure that the dollar remains elevated, above 102.50. We see little downside to the greenback's performance. Moreover, with a lack of liquidity across riskier assets, the dollar creates another avenue for those who wish to hold a safe bet in their portfolios.

Dollar Index vs Gold-Yield and Gold-Dollar Correlation

Gold-Dollar correlation has stabilised at slightly negative in recent months.



Source: Bloomberg, Sucden Financial

However, the tide for the dollar will turn eventually, with the bear trend picking up pace in H2 2024 as the short end of the US curve substantially lowers. Markets are now asking two main questions in regard to the outlook for the greenback over the long term: when will the cutting cycle begin? and how many cuts will we see this year?

Anticipation of rate cuts will drive the first half of the year, adding volatility to corresponding assets, including the dollar. We expect this to be a more gradual process, and the dollar's representation of relative economic robustness to other economies will provide support for the index in the meantime. The biggest shift should take place at the time when many central banks will start easing their monetary policy. This is likely to impact the dollar from Q2 onward as markets begin to price in the first Fed cut. So far, the Fed is keeping the higher-for-longer alive, trying to keep market expectations in regard to interest rates at an elevated level. Indeed, higher yields are doing the job for the central bank without adding the need for further hikes. Hence, we expect that the central bank will keep that narrative intact for as long as possible, acknowledging that a statement reversal could completely discount the work that has been done so far, prompting yields to weaken substantially. Once the first cut is fully priced in, we expect investors to account for the subsequent cuts for the remainder of the year, further discounting the dollar valuation. In our view, the path for the central bank easing will be mirroring the start of the hiking cycle: slow and steady cuts, at 25bps, with a "data-driven" narrative for the remainder of the cycle.

Desk Comments

GBP

Inflation in the UK remains above the BOE target rate highlighted by the latest CPI release of 4%. The upside surprise can be attributed to a large increase in airfare prices. Despite the headline number, inflation remains on course to fall below the 2% target in Q2 paving the way for a first rate cut by June as the BOE will shift its attention away from high inflation to propping up a stagnant economy. Evidence of easing inflation can be seen in the labour market, with average earnings falling to 6.5%.

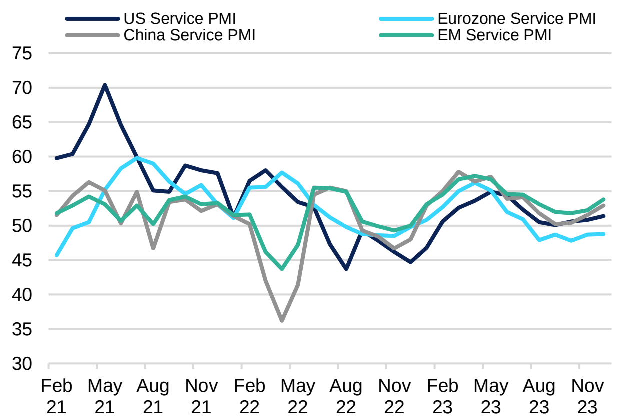
GBP has lacked direction in the past few weeks, consolidating in a tight range. Retail sales has disappointed, contracting 3.2% last month, the worst reading since January 2021. However, recent PMI data has shifted momentum to the upside. The data beat expectations with services moving further into expansion territory and manufacturing ticking higher. The data has started to diverge from the eurozone and emphasises further growth in the UK. In addition, the stickier inflation in the UK may lead to BOE lagging behind its peers in cutting rates supporting the ccy further in the near term. GBP is already the strongest performing currency this year and we expect GBP remain rangebound with an upside bias. A break above recent highs at 1.28 may see GBP accelerate higher and test 1.3142 level.

EUR

EUR has started the year on the backfoot after a gloomier economic outlook. PMI data continues to disappoint and underlines a weakness in the economy, but it perhaps indicates stagnation rather than a recession on the horizon. Inflation as with other economies is on the decline but is driven by cyclical factors such as oil and energy prices. Structural inflation is growing steadily driven by a rise in wages which is growing positively and will challenge the ECB to continue to drive prices lower.

Global Service PMIs Performance

Global service performance improved in recent months.



Source: S&P Global

As expected, the ECB left the policy rate unchanged at 4% and Lagarde delivered a relatively dovish message. She was less concerned with the upside risks of inflation and wage pressures and focused on the downside risks to growth. This was interpreted as less of a pushback on what the market is pricing and brings the April meeting as a possibility to cut. Market is now pricing 3 cuts by July.

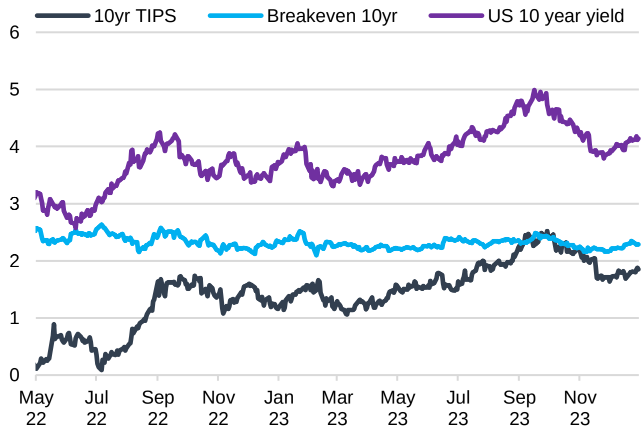
This has pushed the EUR towards December lows. We see any short term buying in the EUR as a good opportunity to sell as we favour a move to the downside. Vols are realising lower and with many of the macro risks released already any move higher is unlikely to find momentum and may be met with resistance.

USD

The USD has started the year on the front foot with markets scaling back their expectations on the timing of any rate cuts. Data in January has shown the US economy is robust and flurry of inflation data from elsewhere has seen market scale back expectations of disinflation in 2024. As a result, long yields have gone up by 25 basis points and market now expect ~ 135 basis points compared to 165 basis point end of last year; with first cuts now expected in May rather than March. We have seen yields consolidate lately and as result USD momentum upside has waned. We expect US economy to remain resilient in Q1, with market participants likely to pay more attention to economic data for signs of deterioration in growth, rather than inflation to determine the timing of future cuts.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Breakeven yield is drifting higher as US nominal yield strengthens, rising back above 4.00%.



Source: Federal Reserve

The desk believe rate cuts in the US are unlikely until May aligning with market expectations, but where we differ including our own research department is when cuts do begin, they are likely to be more aggressive then the anticipated 25 basis points. This has been a common occurrence when you look through history and furthermore Powell has expressed, he wants to avoid premature action and have certainty Inflation risk have abated before acting. We believe this will lead to Fed acting more aggressively than market anticipate, especially given the current monetary policy is geared to tackling high inflation environment which we are no longer in.

We expect the dollar to remain in a range in Q1 and then weaken in Q2 against other Majors. USD's performance against EM will be determined on the magnitude of slowdown in the US at time monetary policy starts easing.

Technical Analysis

Dollar Index

Dollar index has been trading sideways in a broad range since start of 2022, currently sits on the 13-week moving average. On the upside, a break above Red downtrend line/ Span 2 could see market test highs of the range @ 107.30, with resistance beyond there coming at 108.972/ 111.19. On the downside, there is plenty of support protecting the bottom of range, but a close below 200 week MA will pave the way for larger retracement down towards 95 regions.

GBPUSD

GBPUSD has been consolidating in a small range and lacking direction. On the upside, a close above the 200-week moving average likely to lead to retest of 2023 highs at 1.3142, with a break above could see the cross target 2022 highs @ 1.3749. On the downside, a break below 1.25 and white trendline would likely lead to further declines to green trendline, a close below could pave the way for a move down to 1.18, with support beyond there coming at 1.1420 (61.8% fib).

EURUSD

EURUSD failed to break above 200-day MA or close above white downtrend and remains between white/red trendline wedge. We expect the market to continue consolidating with a breakout of the 2 Red trendlines indicating next direction. On the upside, a break above Red trendline/200day Ma could see market test highs from July @ 1.1276, with resistance beyond there coming at 1.1495/1.1500. On the downside, close below the triangle could see the retest 1.05 / 1.0448(lows from Sep), with a break below likely to lead to further declines to 1.02 (61.8% Fib).

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