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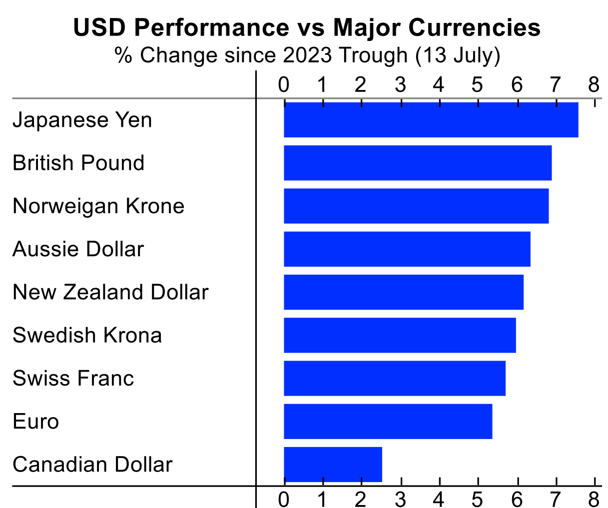
FX Insights

Can Anything Dethrone ‘King Dollar’?

- **In September 2022, the US dollar index (DXY) roared to a 20-year high of nearly 115. Consensus in FX markets was for it to sell off sharply to sub 100 in 2023, as the US slipped into recession under the weight of higher interest rates. Sure enough, the DXY tumbled through late 2022 and early 2023, as views firmed that the world’s largest economy was on the precipice of recession.**
- **But fast forward to today, and the DXY is trading at its highest level since November 2022 after a stunning renaissance over the past three months. The rally has largely been underpinned by the surprising resilience of the US economy. The ‘soft-landing’ scenario is becoming increasingly plausible, driving a repricing in interest rate expectations.**
- **The US sovereign yield curve has shifted higher and steepened. The steepening of the curve has been driven by the longer end of the yield curve; the US 10-year treasury yield reached a high of 4.56% this morning - it’s highest since October 2007 (ahead of the GFC).**
- **Given growing expectations for a ‘goldilocks’ scenario, the FX market is likely to be hyper-sensitive to any sign that the soft landing is on a wobbly footing. This presents an asymmetric response to incoming information, which we argue presents downside risk to the US dollar should the data soften from here.**
- **However, an increase in the supply of US treasury securities – driven by the US Treasury’s funding task, the winding down of the Fed’s balance sheet and potential FX market intervention from the Bank of Japan – may support higher US yields and could even prompt further near-term strength in the DXY.**
- **Just like monetary policy, the trajectory of the US dollar will hinge on the incoming data. In particular, what the data flow means for the prospect of a soft landing in the US.**



In 2022, the US dollar earnt its status as ‘king dollar’. On the back of surging inflation and rapidly rising interest rates the DXY index, which measures the strength of the US dollar against a basket of major currencies, roared to a 20-year high of 114.78 in September 2022. The strength in the dollar was broad based, meaning that depreciations in most major currencies could be largely explained by movements in the DXY.

The consensus in FX markets back in 2022 was for the DXY to shift sharply lower and sub 100, as the US economy slipped into recession under the weight of higher interest rates. Economic performance in other countries, particularly Asian economies, was also expected to be relatively better than in the US. These factors were expected to erode the tailwind from positive relative growth and interest-rate differentials. Additionally, safe-haven demand for the DXY was expected to gradually subside as global market volatility reduced as central banks got on top of inflation.

Sure enough, the DXY tumbled around 12% from its peak in September 2022 to scrape the 100 level at the beginning of February 2023. After some volatility in the wake of the collapse of the Silicon Valley Bank (SVB) in March, the DXY continued its march lower as views firmed that the world’s largest economy was on the precipice of recession.

But fast forward to today, and the DXY is trading at around 106, its highest level since November 2022 after a stunning renaissance over the past three months. And while this is some way off the highs of 2022, it’s still very much reflective of an outperforming DXY, which continues to dominate the price action of other major currencies.

Since 13 July, that marks the start of the recent re-acceleration in the DXY rally, the DXY has jumped a whopping 6.5% as the US dollar has appreciated against every one of its G-10 peers. This includes the Aussie dollar, which remains heavy around the 0.6350-0.6450 range after tumbling from as high as 69 US cents since mid July.

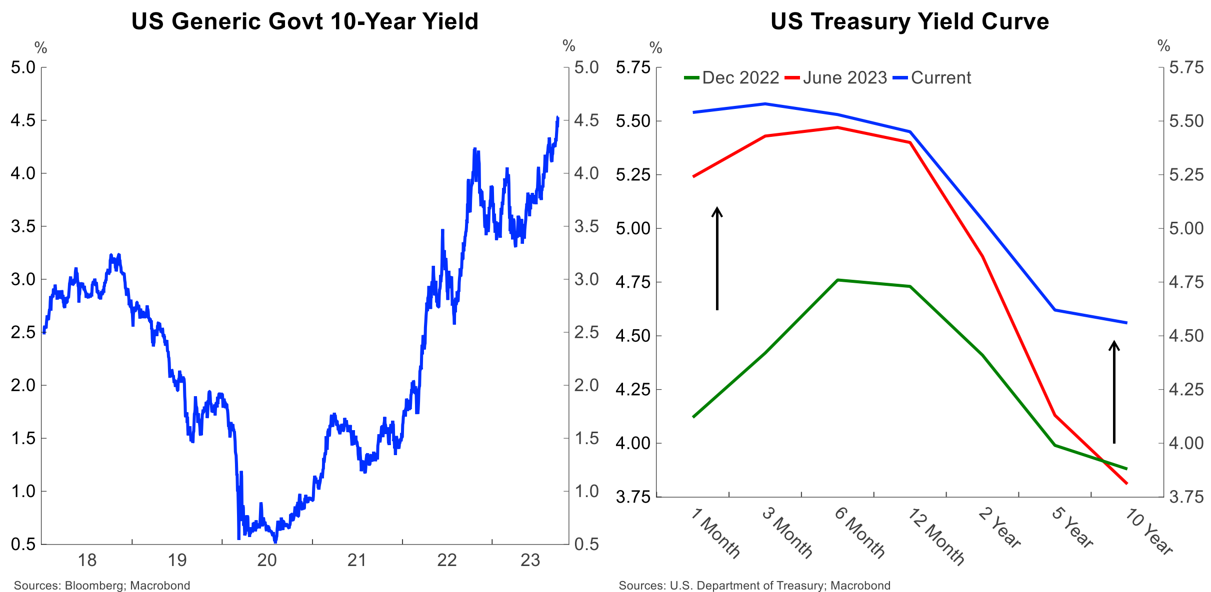
What’s driven the resurgent DXY?

The recent rally in the DXY has largely been underpinned by the surprising resilience of the US economy, which has prompted a revision of calls that the US will tip into recession. The ‘soft landing’ scenario where the Federal Reserve engineers a return to its 2% inflation target without a meaningful deterioration in the labour market is becoming increasingly plausible.

The improvement in supply-side disruptions in the global economy has seen core inflation in the US fall to 3.7% over the year to August, well down from the peak of 6.6% in September 2022. Meanwhile, wages growth has decelerated without a material increase in the unemployment rate, as supply and demand in the labour market slowly rebalance. The consumer has also proved more resilient than expected, supporting solid economic activity alongside robust business investment.

The resilience of the US economy has bolstered expectations around the odds of a soft landing in the US. In turn, this has driven a repricing in interest rate markets to align with the higher-for-longer mantra that has been sung by Fed officials for some time. That is, expectations for rate cuts have been pushed out and scaled back because the market no longer sees an imminent need for the Fed to come to the rescue with sharp rate cuts.

In combination with other factors, this repricing in interest rate expectations has seen the US yield curve shift higher and steepen. The steepening of the curve has been driven by the longer end of the yield curve (i.e. a bear steepening). The US 10-year treasury yield reached a high of 4.56% early this morning - it’s highest rate since 2007. Importantly, this increase in yields has been mirrored in real (i.e. inflation adjusted) rates, meaning that the jump in yields is not a reflection of expected stickiness or volatility of inflation, but rather a stronger underlying outlook for the US economy.



Outlook

There are two key factors to consider for the DXY outlook in the near term. First, whether the soft landing narrative has legs and, second, the supply and demand for US treasuries.

The Soft Landing

Markets are grappling with one fundamental question when it comes to the macroeconomic outlook. That is, are things different this time or are the historical relationships still intact, but just operating with a longer lag?

The historical evidence would suggest that a soft landing scenario is near impossible to achieve and that to get inflation down to target, the Fed may well need to engineer a recession. However, there are many aspects of this economic cycle which are unique. The global economy has never experienced such a large and coordinated shock to both supply and demand as was experienced during the pandemic. Economists have also made the argument that inflation expectations are better anchored than in previous inflationary episodes as inflation targeting is a relatively new policy feature. This alone may be enough to consider the historical experience with caution.

But there is also plenty of reason to believe that the pandemic had no structural impact on the economy and that once the seismic imbalances from the pandemic (e.g. elevated household and business savings buffers, low fixed-rate debt, excess labour demand, etc) have been ironed out, the full impact of tighter monetary policy will be felt.

The recent resilience in US economic indicators has supported the soft landing narrative. But if the economic data becomes inconsistent with this outcome, the optimism around a soft landing could quickly unwind. This could reverse the recent recalibration in interest rate expectations and weigh down on the US dollar.

Given growing expectations for a 'goldilocks' scenario the FX market is likely to be hyper-sensitive to any sign that the soft landing is on a wobbly footing. Conversely, while further evidence that the soft landing is in-tact will provide markets with more conviction, the outlook priced into markets can't get much rosier.

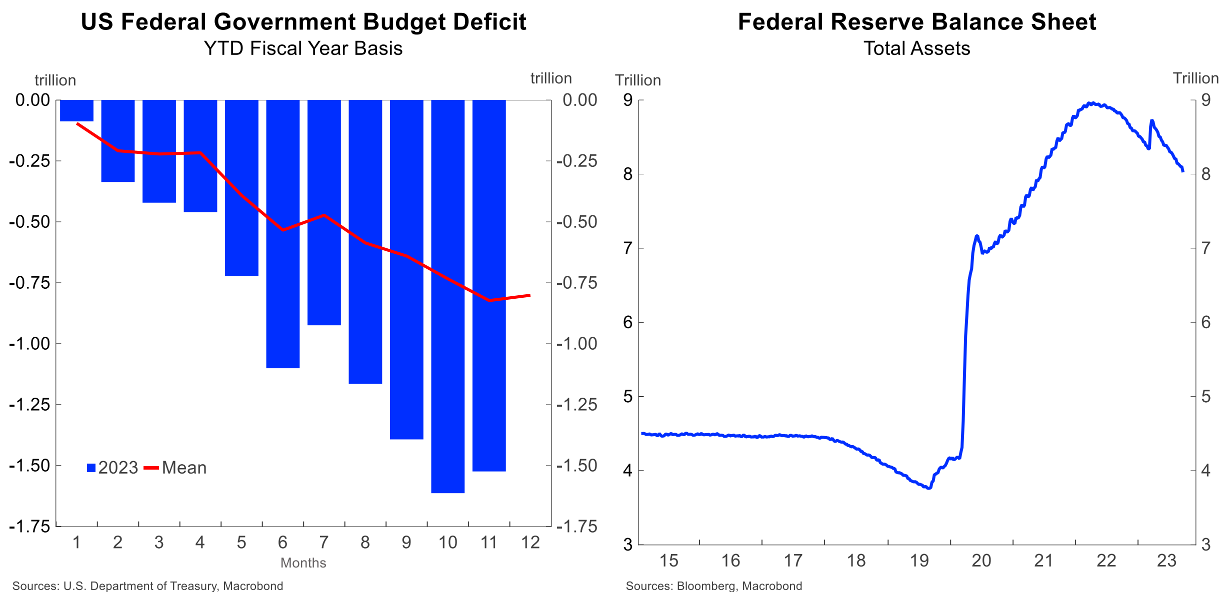
This presents an asymmetric response to incoming information which we argue presents downside risk to the US dollar, should the data soften from here.

Supply and Demand of Treasuries

While the viability of the soft-landing scenario is crucial for the evolution of interest rates, there are also some other independent factors which could put upward pressure on the US yield curve and support DXY strength. These relate to the supply and demand for US treasuries.

On the supply-side, the US Federal government continues to run large budget deficits. So far during the 2023 US fiscal year (October 2022 to August 2023), the US government is running a deficit of $1.52 trillion (equivalent to 5.7% of GDP). This needs to be funded through the issuance of treasuries or T-bills which increases the supply of government bonds. The process of raising funding was roadblocked by the political stalemate on the US debt ceiling, so there is also an element of catch up at play here.

That is just the new debt. There is also a significant refinancing task ahead for the US Treasury because existing securities mature and need to be refinanced. Add to that the unwinding of the Fed's quantitative easing programme (dubbed 'quantitative tightening'), which is currently adding around $60 billion in treasuries to the market each month.



The biggest holders of US treasuries are global central banks. They hold these instruments as part of their currency reserves. The dominant players are the Bank of Japan (BoJ) and the People's Bank of China (PBoC). Both the Japanese yen (JPY) and the Chinese yuan (CNH) are under pressure against the US dollar, introducing the risk of market intervention to defend their currencies. Should either central bank intervene in the FX market, they will need to draw on their foreign currency reserves to buy their domestic currencies. This could see one or both central banks switch from buyers to sellers, further increasing the supply of US treasuries to the market.

Greater supply of treasuries, all else equal, will put downward pressure on prices and upward pressure on yields, supporting an appreciation of the DXY.

On the demand side, growing political polarisation and frictions in the governance structures of the US Government may weigh on demand for US treasuries. This is best illustrated in the recent debt ceiling stalemate and the possibility of an imminent government shutdown on 1 October 2023. Episodes like this undermine the attractiveness and perceived safety of US treasuries, weakening demand.

These demand and supply dynamics suggest there remain upside risks to US treasury yields from a fundamental perspective. A further increase in US treasury yields would continue to support the DXY and could even prompt further upside strength. These factors are likely to persist for some

time, but alone are not enough to offset movements in the yield curve driven by interest-rate expectations.

Conclusion

The macroeconomic backdrop presents some downside risk to the DXY given the market is increasingly pricing in a ‘goldilocks’ economic scenario. However, fundamental support for the US yield curve will remain a tailwind and could see the DXY drift higher in the very near term.

But just like US monetary policy, the trajectory of the DXY will hinge on the incoming data. In particular, what the data flow means for the prospect of a soft landing.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (26 Sep)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.14	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.24	3.95	3.90	3.80	3.70	3.60	3.50
10 Year Bond, %	4.40	4.00	3.80	3.60	3.40	3.30	3.22
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.54	4.10	3.90	3.70	3.50	3.40	3.30
USD Exchange Rates:							
AUD-USD	0.6397	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	149.07	144	142	140	138	136	133
EUR-USD	1.0572	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2158	1.27	1.28	1.29	1.30	1.30	1.30
NZD-USD	0.5945	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6397	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.6050	0.60	0.60	0.61	0.61	0.61	0.62
AUD-JPY	95.36	95.0	95.1	95.2	95.2	95.2	94.4
AUD-GBP	0.5262	0.52	0.52	0.53	0.53	0.54	0.55
AUD-NZD	1.0761	1.08	1.10	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	3.9	3.2
CPI (Trimmed mean), %	2.6	6.9	3.8	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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