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Chief Investment Office GWM
Investment Research

Currency markets: Reviewing the US dollar

Currency markets

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- The USD is finding support from the latest FOMC meeting, which signaled it intends to keep policy rates higher for longer. In contrast, major central banks in Europe have mostly disappointed market expectations.
- We now think that the greenback will stay well-bid till end-2023, and we accordingly changed our forecasts across key currency pairs.
- Short term, we like to use option markets for yield pickup when it comes to the USD, while investors should consider gainers from higher energy prices (NOK, the AUD, or the CAD) in the crosses.

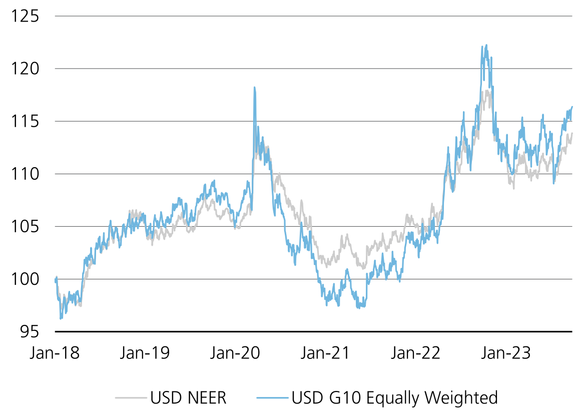
Source: UBS

The US dollar has retained its "market darling" status thanks to the Federal Reserve communicating a hawkish pause compared to other key central banks who have been more balanced in their guidance. Meanwhile, among the G10, some currencies have emerged as potential performers over the past month. Commodity-linked currencies have been able to hold their ground versus the USD. In contrast, low yielders and less liquid currencies have underperformed.

As recent weeks have taught us, central banks that leave the door open for further rate hikes do not necessarily guarantee automatic support for currencies. The underlying economic growth story is equally important. Where the economy is at risk of a recession, a "dovish hike" or a "hawkish hold" on policy rates does not impress markets as has been the case for European currencies. In this context, the US is probably the only economy that can still withstand higher rates in the short run. But it's also clear the Fed would prefer not to tighten policy further unless forced to by stronger economic data. To reflect a backdrop of higher US rates for longer, we have once again reduced our USD depreciation expectations materially; the US dollar is unlikely to fall from its pedestal into the year-end. That said, it should ultimately weaken as US GDP growth slows next year. In the crosses, we see value in commodity-linked currencies, and would make use of option volatility to beef up money market returns, while seeking selective exposure to emerging market currencies with a high yield.

Broad USD strength on the back of US exceptionalism

Values standardized to 100



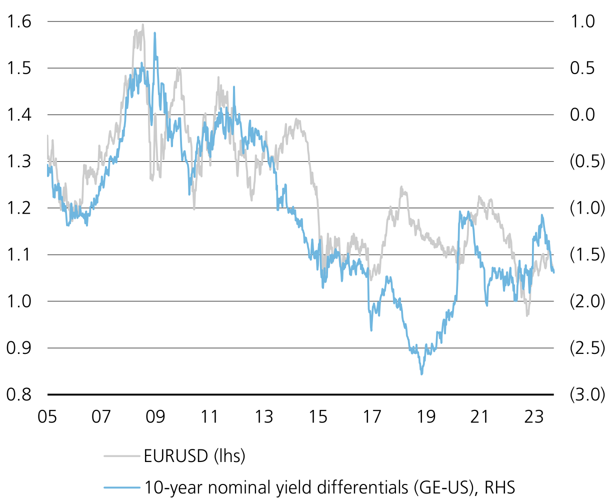
Source: Bloomberg, UBS, as of September 2023

Reviewing the US dollar

Elevated interest rates and robust economic growth in the US relative to the rest of the world have provided broad USD support over the past two months. Looking at what drove US rates higher, we see it was mostly economic growth surprises out of the US rather than inflation surprises that triggered the rise in longer-dated rates. While markets' terminal policy rate expectations for the Fed stayed more stable, the implied pricing for rate cuts next year has been trimmed, thanks to the Fed's signal that rates may stay higher for longer.

Longer-dated interest rate differentials have been running in favor of the USD

Weekly data, rhs values in %



Source: Bloomberg, UBS, as of September 2023

With inflation rolling over globally, we expect policy rate hikes to be over by 4Q this year, with the market now looking into 2024 on how long current rates can be sustained. With this in the backdrop, we think currency markets will be shaped by news on growth. Where investors are confident that the underlying economy can manage current interest rate levels, we expect the respective currency to be well bid.

Considering the latest macroeconomic data, the narrative that the Fed needs to cut policy rates before the ECB is questionable. Hence, there is risk that the USD might gain further versus the EUR, and EURUSD could slip back below 1.05. GDP growth in the US has held up much better than expected or compared to other countries although signs of slowing are emerging. Growth-linked data out of Europe and China has been soft and have not lived up to market expectations.

In order for markets to become confident about the economies and currencies of Europe and China, we need some good news about GDP growth. Particularly for Europe, it's hard to expect an immediate turnaround. For a new goods-linked restocking cycle in the developed world to begin there must be some positive macro data or energy prices (natural gas and oil) need to come down. Neither driver is expected to materialize for the rest of this year.

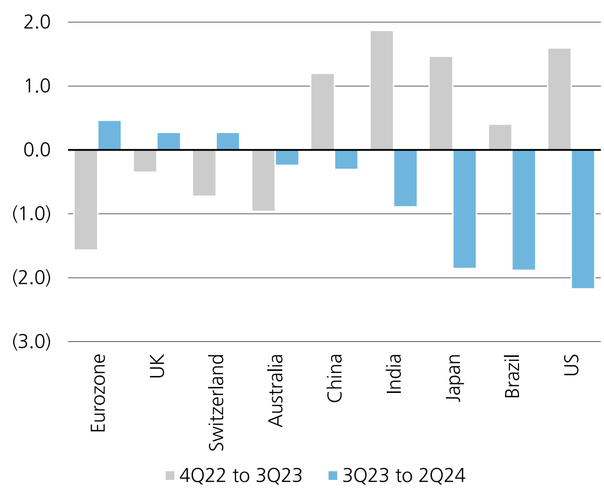
That said, if China's efforts to stabilize its property sector and the broader economy, with recent additional policy measures, come to fruition, growth sentiment outside the US could improve and be supportive of pro-growth currencies like the EUR, the GBP, and the AUD. Moreover, to the extent that GDP growth expectations for Europe and China are on the low side, this leaves room for upside surprises and could help short-term USD momentum to be curbed.

Longer term considerations

Notwithstanding near term USD strength, US economic activity should still step down as we expect excess savings to be used up by year-end and higher interest rates to weigh on US consumer spending. In short, the US economy has yet to bottom, while Europe and China already have. So, we are still left with relative growth dynamics that should run against the USD in 1H24.

Relative growth dynamics should run against the USD in 2024

Growth delta from 4Q22 to 3Q23 and from 3Q23 to 2Q24



Source: UBS, as of September 2023

The speed at which the US economy slows matters as well. If the US economy continues to slow only modestly because consumer demand or fiscal spending comes in strongly ahead of the US elections, current market expectations for lower US rates could be revised higher still. So the market could completely price out all rate cuts for next year. For now, this remains a risk case.

Conversely, a hard landing, with risk assets under downward pressure, could temporarily support the USD. The USD tends to perform positively in a risk-off environment. However, for this to happen, the starting point matters as well. A richly-valued USD on the back of US exceptionalism is unlikely to benefit greatly from risk-off forces if the same narrative goes into reverse gear. This would change if the weakness in US accelerates an already weak growth backdrop outside the US or if the geopolitical situation in Europe changes for the worse.

So, different permutations of macroeconomic and geopolitical conditions provide an array of currency paths for the USD. While the USD path is more uncertain, we stick to the view that the end point for the USD is clearer. Fed rate cuts to the tune of 50–100bps (or more) in 2024 should ultimately take USD support away with yield differentials becoming less USD supportive. Structural USD negatives, like twin deficits, are still here although the currency market appears to be paying little to no attention to them for now. But positioning for a USD reversal require first a halt in USD momentum and macroeconomic news in the US to turn.

Commodity currencies find some support

Besides relative growth dynamics, higher energy prices and to some degree bulk commodities (iron ore and coking coal), add another differentiating factor to currency markets. The direct commodity impact on USDCAD, USDNOK, and AUDUSD might be more limited. The US has become a beneficiary of higher energy prices, although the impacts on its balance of payments is not expected to alter its overall current account backdrop.

A cleaner way to observe the impact of higher oil or bulk commodity prices is in the crosses. In recent weeks, the CAD, the AUD, the BRL, and the NOK have outperformed in relative terms, i.e., versus the EUR, the GBP, the SEK, and the JPY. We think this gives rise to opportunities to be long NOKSEK or AUDGBP for example, while EURCAD has room to slide a bit more before a likely USD reversal stalls the pairing next year.

Where should we still sell volatility?

The opportunity set in currency markets does not end with relative trades. We think that currencies like the AUD, the JPY, or the NOK are standing at structurally low levels. If we combine this valuation backdrop with these currencies' attractive option volatility backdrop versus the USD, the EUR, the CHF, or the GBP, the conditions are still in place for investors to sell the upside risks in the USD, the EUR, the CHF, and the GBP for a yield pickup over the coming three months. By doing so, investors could stick to their initial FX position while also capitalizing on our currency view and beefing up their money market returns. We favor investment tenors of 3 months.

Changes to our forecasts

To reflect the risk of higher-for-longer US rates amid a more resilient economic growth backdrop in the US, we have further trimmed our expectations of a weaker USD. Until the year-end, we now expect the USD to trade sideways versus most currencies. We now expect EURUSD, USDCHF, and GBPUSD to trade at 1.06 (previously 1.12), 0.92 (0.87), and 1.20 (1.29), respectively, by end-December. And in Asia Pacific, we now expect USDJPY and AUDUSD to trade at 145 (previously 142) and 0.65 (0.66), respectively, by end-December. The near-term risks are skewed towards additional USD strength, so EURUSD may slip temporarily below support at 1.05, USDCHF may trade above 0.92, and GBPCHF may drop below 1.20.

Our **new** currency forecasts

Key currency pairings

FX Pair	26-09-23	Dec 23	Mar 24	Jun 24	Sep 24
EURUSD	1.06	1.06	1.08	1.10	1.12
EURCHF	0.97	0.97	0.97	0.97	0.97
USDCHF	0.91	0.92	0.90	0.88	0.87
GBPUSD	1.22	1.20	1.24	1.28	1.30
EURGBP	0.87	0.88	0.87	0.86	0.86
GBPCHF	1.11	1.10	1.11	1.13	1.13
USDJPY	149	145	143	140	136
EURJPY	157	154	154	154	152
USDCAD	1.35	1.32	1.31	1.30	1.29
AUDUSD	0.64	0.65	0.67	0.69	0.71
NZDUSD	0.59	0.61	0.62	0.63	0.63
EURSEK	11.65	12.00	11.90	11.80	11.70
EURNOK	11.44	11.30	11.10	11.00	10.80

Source: Refinitiv, UBS, as of 26 September 2023

As for our longer-term USD view, we still expect USD strength to peak next year and give up some gains. We reflect this in EURUSD, USDCHF, and GBPUSD with our September 2024 forecasts at 1.12 (previously 1.16), 0.87 (0.84), and 1.30 (1.36), respectively, by end-December. This view requires Europe to stay out of recession and China to stabilize.

Indeed, recent Chinese data has shown some signs of bottoming out, thanks to a series of fiscal and monetary stimulus measures over the past two months—this supports our view that the AUD relative underperformance could be behind us. In Japan, we see the potential for the central bank to remove its yield curve control (YCC) and negative interest rate policy (NIRP) regimes in 1Q24 and 2Q24, respectively. Both factors should lay the ground for a potential outperformance of AUD and JPY in the cross next year.

USD based investors

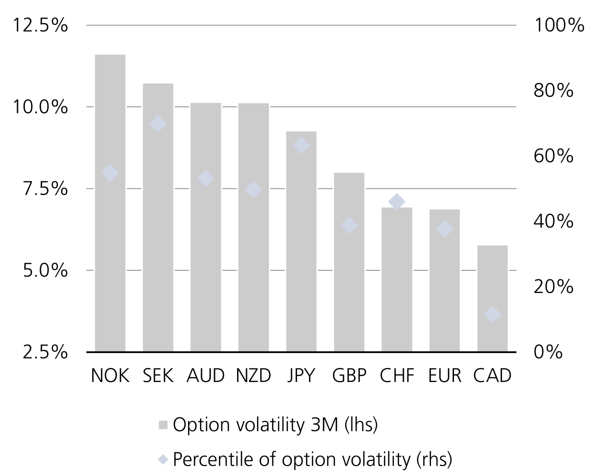
Yield pickup in AUDUSD
We expect Chinese stimulus measures to yield some stabilization of China's economy. This should become more apparent in the coming months. Moreover, we also believe Australia's economy will make a soft landing in 2024. Investors should keep in mind unemployment remains near its lowest levels in 50 years, and higher domestic hours worked and a greater participation rate all signal resilience in household incomes. Elevated volatility compared to other pairing makes selling the downside risks from AUDUSD 0.63 downward still very attractive, in our view.

Yield pickup in USDNOK
The weaker krone this year is keeping the Norges Bank on a hawkish bias, while USDNOK is showing signs of a top. The Norwegian economy has been remarkably resilient and higher oil prices have yet to give the currency some support. This view requires that US data starts to roll over, while rising oil prices and booming oil investments give the NOK a helping hand. Alongside an attractive volatility backdrop in USDNOK, we recommend selling the upside risks of the pairing above 11 over for a yield pickup over 3 months.

Yield pickup in USDJPY (new)
The Bank of Japan has increasingly shown concern over the weakness in the yen exchange rate. BoJ Governor Ueda signaled that additional policy shifts could be considered, even after the recent YCC adjustment in July. Key motivation for the latest hawkish comments is to contain yen weakness, where authorities would not welcome a rise beyond the 150 level for the USDJPY exchange rate. From this perspective, we favor selling the upside risk in USDJPY at or above the 150 level over the next 3 months.

The historical volatility backdrop varies strongly across the G10 FX complex

ATM option volatility, observation window since 2015



Source: Bloomberg, UBS, as of September 2023

EUR-based investors

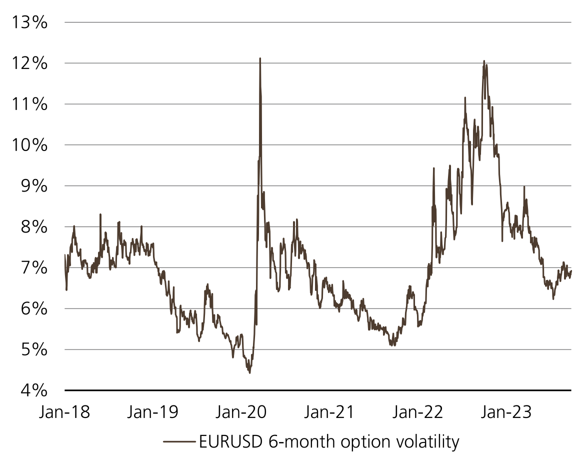
Active EURNOK short (new)
The weak krone, along with the resilient labor market and household inflation expectations picking up, should keep the Norges Bank on its toes, whereas the ECB may have ended its tightening cycle. This could pull the NOK out of its detrimental carry situation. We advise to be long NOK outright. Moreover, rising oil prices and decreased focus on the FX purchases from the Norges Bank are a favorable backdrop for the krone. We thus recommend being short EURNOK with a target of 11.0 by the end of Q2 next year.

Range-trading against the USD (new)
EURUSD has been a rollercoaster this year, with the USD likely to stay well-bid until year-end. We recommend EUR-based investors to look for range strategies versus the USD (EURUSD 1.02-1.08). We think offsetting forces are at work that should trigger a EURUSD sideways move from here. Higher US yields, but still slower growth ahead, suggest that the EURUSD trajectory is unlikely to be a one-way street. A growth stabilization outside the US should help to keep EURUSD more anchored as well.

Yield pickup in EURJPY
We reiterate our belief that the recent highs of 159 – 160 in EURJPY should mark a peak. This favors selling the upside risk above these levels for a yield pickup. We expect the yield differentials to stabilize and to narrow next year. The Bank of Japan has signaled greater concern over the weakness of JPY and signaled that it could consider further policy normalization. With the Japan authorities leaning against further yen weakness, we think the upside risk for EURJPY to rise significantly beyond 160 looks rather limited.

Option volatility in EURUSD points to more contained exchange rate fluctuations

Weekly data, ATM options



Source: Bloomberg, UBS, as of September 2023

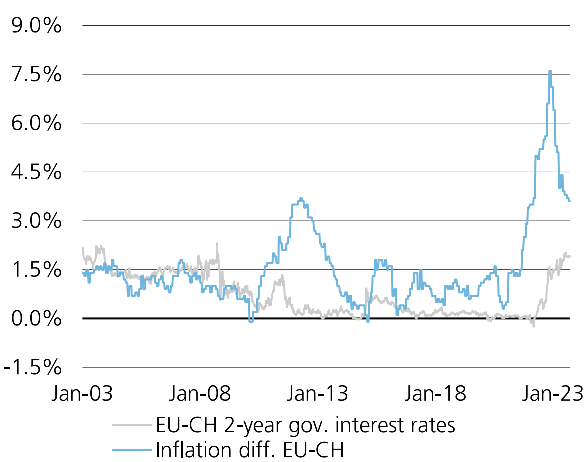
CHF-based investors

Range-trading against the USD (new)
We expect USCHF to trade in a large 0.88-0.94 range. In the short-term the USD remains well-bid with the Fed holding high rates for longer as growth is more resilient. This should keep yield differentials in favor of the USD amid an SNB on hold. The SNB committed to protect Switzerland against imported inflation, and should prevent the CHF from weakening too much as well. The downward path for USDCHF will eventually resume, but strongly hinges on the Fed cutting interest rates next year. We therefore see the risks in USDCHF as largely balanced for now.

Carry and range-trading against the EUR
We continue to expect EURCHF to trade fairly range bound with good support at around 0.95 and top around parity. The downside is limited by the large yield differential of more than 200 basis points on the money market. The upside is limited by the SNB's willingness to reduce the large foreign exchange holdings. Selling foreign reserves reduces Swiss francs in circulation, which limits potential inflation pressure. Our range-trading strategies expect that offsetting currency forces keep EURCHF stable and realized volatility closer to historical lows.

Yield pickup in GBPCHF
Wage growth and higher energy prices contribute to stickier inflationary pressures in the UK, while its carry remains one of the most attractive among the G10 complex. The yield differential with Switzerland remains in favor of the UK, after the BoE and the SNB both decided not to hike last week. GBPCHF remains close to the lower-bound of its range, which allows us to sell the downside risks below 1.10 over the next three months.

SNB on hold, taking support away from CHF
Weekly data



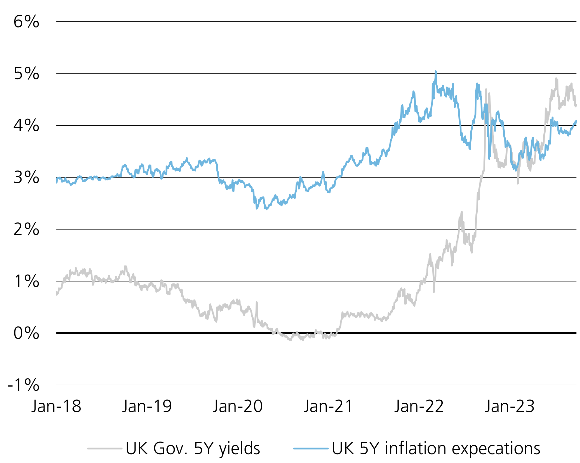
Source: Bloomberg, UBS, as of September 2023

GBP-based investors

Range trading against the USD (new)
UK economic data has signaled a clear cooling which, coupled with a downside surprise in the latest inflation print, leaves the impression that the Bank of England (BoE) has completed its rate hiking journey. Base rates in the UK are likely to remain at current levels through to the summer of next year. Moreover, the BoE continues to shrink its balance sheet. Despite restrictive monetary policy by the BoE, growth concerns in the UK will act as a counterweight and should keep GBP largely range bound from here. On the back of growth concerns, sterling has underperformed in recent sessions. The market's reaction to softer UK data looks well advanced. In a relative space, the UK economy does not look exceptionally weak, moreover interest rates are high, which should give some support to the pairing at these levels. With this yield-growth mix in mind, we expect GBPUSD to be more range bound. To the downside we see good support at 1.19, while to the upside we look for a top at 1.26.

Yield pickup in GBPJPY
We reiterate our view that the recent GBPJPY highs of around 185-186 look toppish, and favor selling the upside risk in the currency pair from 183 onwards for two reasons. First, from a positioning perspective, markets are currently holding elevated net-long GBP positioning and net-short JPY positioning. Second, market expectations for BoE rate hikes are well priced compared to the potential for the Bank of Japan to undertake further policy shifts, based on its recent signals. Alongside a highly competitive Japanese economy, the risk reward in GBPJPY looks asymmetrically skewed to the downside from current levels over the next six months.

UK yields should give some GBP support considering ongoing growth concerns
Daily data



Source: Bloomberg, UBS, as of September 2023

Beyond G10 currencies

JPY-based investors: Yield pickup in AUDJPY

Given the low interest rates in Japan, we recommend JPY-based investors sell the downside risk in AUDJPY at or below 93.8 for a yield pickup over three months. We believe the downside risk for AUDJPY to be limited. While the AUDJPY has been recovering over the past month, we see more room for the exchange rate to continue its uptrend, especially since latest Chinese economic data are showing signs of bottoming out. A stabilization in China's growth towards year-end could also trigger some liquidation of AUD short positions by speculative accounts and provide a further tailwind for the AUDJPY exchange rate.

CNY-based investors: Yield pickup in CNYJPY

With short-term interest rates in China still relatively low (1-year deposit rate around 1.5%), we recommend yield pickup strategies via selling CNYJPY upside risks. The CNY and JPY have both underperformed other major currencies year-to-date due to the dovish policy bias from their central banks. Although the CNYJPY has risen above the 19-20 range since late August, we believe further upside is limited, considering that the Bank of Japan has become increasingly concerned over recent yen weakness. Moreover, the likelihood of a strong near-term rebound in CNY should also be limited by the People's Bank of China's easing bias, to support Chinese economic growth. As such, we reiterate our view that the currency pair remains attractive for a short-term yield pickup strategy.

China entering a low rate environment

Weekly data

Source: Bloomberg, UBS, as of September 2023

SGD-based investors: Active Long AUDSGD

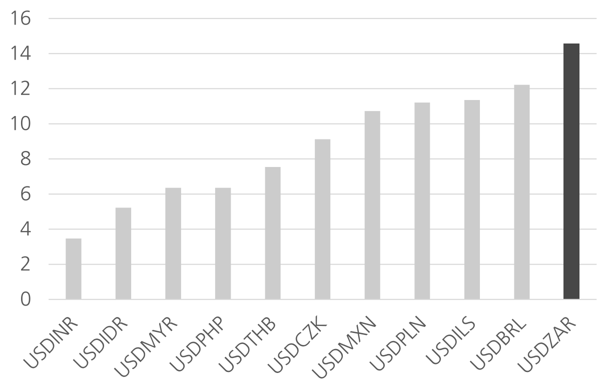
We have an existing short-term trade to go long AUDSGD (entry level 0.876), targeting 0.92 with a stop-loss of 0.86. We believe the recent low in AUDSGD (of around 0.866 in early September) marks a bottom and see further upside for the pair with the AUD getting a tailwind from latest improvement in Chinese economic data. On the other hand, we expect the SGD to underperform the AUD, with the Monetary Authority of Singapore having downshifted to a neutral policy bias, citing rising risks to global growth and easing risks to inflation.

Yield pickup opportunities in emerging market currencies

Emerging market currencies continued to struggle into September as US yields stayed high and worries over China's growth outlook persisted. With larger moves and uncertainty being priced, we do see attractive levels to sell upside or downside in select currency pairs for yield pickup. Our most preferred pick is the South African rand, as it tends to move strongly with global dynamics and features high implied volatilities. We think the medium- to longer-term outlook for the rand is positive, as the country is making progress to deal with its electricity shortages and should benefit from a stabilizing growth picture in China. We would sell the upside in USDZAR from USDZAR 20 onwards over three months. In recent weeks, other opportunities have emerged as well: Selling the upside in USDILS with strikes around USDILS 4.00, selling the upside in USDMXN in the high 18s, or the downside in EURPLN close to 4.50 are valid options for investors with adequate risk budgets.

Rand stands out for yield enhancement in terms of implied volatility on offer

One-month implied volatilities for emerging market currencies



Source: Bloomberg, UBS, as of September 2023

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