For investors with medium- to longer-term horizons, CIO recommends setting exit levels to curb excessive long USD exposure and making use of the option market for yield pickup. (ddp)

What's next for the US dollar?

22 February 2023, 5:51 pm CET, written by UBS Editorial Team

The US dollar has strengthened this month as markets moved to reprice the peak fed funds rate amid robust US economic data in recent weeks. However, we maintain the view that the near-term boost to the USD is likely to be short-lived. We expect the currency to weaken by year-end.

The US dollar strengthened amid robust economic data.

- Strong labor market data, a buoyant service sector, and robust retail sales are some of the recent indicators that the US economy is more resilient than anticipated, fueling expectations of further Fed tightening.
- The federal funds futures market now implies a peak rate of nearly 5.3%, up from 4.81% on 1 February, when the Fed raised rates by 25 basis points.
- The DXY index is up 2.8% so far in February.

But we expect further USD weakness by year-end.

- While Fed chair Jerome Powell signaled there is still a "significant road ahead" to cool inflation, we see price pressures easing through 2023, with the end of the US central bank's current hiking cycle in sight.
- The pace and scale of additional rate hikes are unlikely to match those of 2022.
- China's reopening and an improving ex-US GDP growth outlook should weigh on the greenback.

We rate the AUD as most preferred.

- The Australian dollar is supported by China's reopening, Australia's relatively strong economic growth, and a central bank that is likely to keep the reins tight when the Fed starts to ease monetary conditions.
- We recommend being long AUDUSD with a view to holding the position for at least 6–12 months.
- Investors can benefit from USD weakness via short positions versus the AUD and the NZD, or make use of the option market to sell the USD upside for a yield pickup.

Did you know?

- A declining US-Germany 10-year interest rate differential is a headwind for the USD this year. Based on data since 1990, EURUSD rose 1.5% when the yield differential fell over six months and 2.1% over 12 months.
- A rebound in global GDP growth expectations for 2H23 and 2024 should support the euro and the currencies of Asia's major exporters.
- The 425 basis points of tightening the US central bank implemented last year was the fastest since the start of fed funds targeting in 1982. The lackluster 4Q earnings season has reinforced our view that tighter financial conditions are starting to show their effect.

Investment View

For investors with medium- to longer-term horizons, we recommend setting exit levels to curb excessive long USD exposure and making use of the option market for yield pickup. We rate the Australian dollar as most preferred in our FX strategy.

Main contributors - Daisy Tseng, Dominic Schnider

Content is a product of the Chief Investment Office (CIO).

Original report - What's next for the US dollar?, 22 February 2023.

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2021. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.