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CIO think it's too early to expect sustained weakness in the US dollar. (UBS)

The US dollar's retreat looks likely to be temporary

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The US dollar has fallen since last week's milder-than-expected inflation data, which revived hopes of a dovish pivot by the Federal Reserve. At the time of writing, the DXY dollar index is now close to 4% down compared to a day before the release of the October consumer price index release on 10 November, 6% down from its high point earlier this month, and almost 7%down from a 20-year high reached in late September.

Aside from the potential for less hawkish Fed policy, the dollar has also been undermined by a broad recovery in market confidence—with the currency getting less of a boost from safe-haven flows. A mild winter so far has made it easier for European nations to fill up gas stores. Meanwhile, optimism over China has been improved by the government's decision to unveil policies to support the nation's struggling property market and modifications to its policies to combat the spread of COVID-19.

But we think it's too early to expect sustained weakness in the US dollar, and we maintain our view of a USD peak by the end of 1Q23.

The latest US inflation print is just one data point. The moderation in the pace of inflation for October was a welcome development. However, Fed officials have already warned against extrapolating too much from a single month. The Fed's Christopher Waller described the softer-than-expect US inflation release as "just one data point," and said that markets have got "way out in front." Some of the more volatile CPI components can easily tick higher again on a month-over-month basis, while services inflation remains elevated. We believe the Fed will want to see several consecutive months of tamer inflation before considering a pivot to a more dovish stance. In addition, the Fed needs to see signs of a cooling labor market. Yet recent data still points to strong job growth, low unemployment, and fast-rising wages.

Lower natural gas prices in Europe can reverse quickly. This possibility has been underlined by a 30% rally in the price of the TTF gas benchmark over the past few days. Although European storage levels have been filling, a colder winder or an end to Russian supplies next year could lead to a drawdown of gas inventories in 1H23, possibly beyond

historical norms. Should this trigger higher prices, it would likely lead to increased liquefied natural gas (LNG) sales into Europe, creating knock-on effects in the rest of the world. A pick-up in Chinese economic growth next year could also lead to higher demand for LNG. Elevated energy prices have been a negative for the euro, which in turn supports the dollar. The euro is by far the largest component of the DXY dollar index, at close to 58%, compared to 13.6%for the yen, which ranks second in the index.

The Chinese yuan still faces headwinds from lackluster growth at present. China's move to lend support to property developers should help avoid systemic risks, and modifications to the zero-COVID strategy are promising. However, the pick-up in growth should still be gradual. Measures to support the property market are not sufficient to revive buyer appetite and drive up sales, in our view. And while the recalibration of the country's zero COVID policy marks a step toward an eventual reopening, we think a full reopening will have to wait until around 3Q23.

With these market drivers still likely to contribute to volatility, we think the near-term risks remain tilted toward a stronger US dollar. We continue to rate the greenback as most preferred in our foreign exchange strategy, alongside the Swiss franc, another safe-haven currency. We think there is a high chance that risk aversion will return and recommend investors prepare for another drop below parity for the euro (EUR) and sterling to fall toward USD 1.10. We also recommend selling upside risk in EURUSD and the downside risk in the US dollar versus the yen as a short-term yield-enhancement strategy, given the pick-up in foreign exchange volatility.

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