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# FX rebalancing in interesting times

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**The USD's reprieve has turned out to be somewhat short-lived as the Moody's downgrade provided a reminder of overhanging concerns. This elevated volatility in the USD is likely to continue in the near term and investors might use this to rebalance their FX exposure. We would continue to use USD rallies to diversify out of the USD, and into EUR, JPY, GBP, AUD, and gold. The recent market tumult has seen a rare investment opportunity emerge in the otherwise-sleepy USDHKD.**

The downgrading of the last AAA rating on the US by Moody's helped to end the sharp 2.8% rebound in the USD index (DXY) that took place amid a relief rally. The downgrade though provided the market a sharp reminder of the emergent medium-term policy concerns, which had engendered a 10.6% fall in the DXY from mid-January to end-April. With the brief DXY rebound almost-entirely reversed, should investors be bracing for another round of sustained USD weakness?

While we do expect gradual USD weakness over the medium term, in the more immediate future, markets—and investors—will likely have to reconcile the dissonance from disappointments in economic data and trade negotiations, with the broader story of normalization. But rather than worrying about volatility, investors might instead use this opportunity to refresh portfolios by rebalancing their FX exposure.

**Use USD rallies to trim USD exposure.** We think the events of the past four months have left a fairly indelible blemish on the reliability of US policymaking. This in turn will likely mean reduced confidence in the USD and USD assets. Investors should be on the lookout for USD rallies and be ready to trim their exposure to the USD. USD rallies like the one recently, that saw the EURUSD dip slightly below 1.11, would generate good entry levels across a range of currencies and other assets. We favor the EUR, JPY, GBP and AUD as good stores of medium-term value in lieu of the USD. In particular, we expect 1Q2026 levels of 1.18 on the EURUSD, 1.38 on the USDJPY, 1.39 on the GBPUSD, and 0.70 on the AUDUSD.

Gold might also see better entry levels during USD rallies; we would use these to ensure that portfolios are adequately hedged. The recent USD rally coincided with a risk appetite revival, and pushed the gold price down from its recent highs around USD 3500/oz to around USD 3200/oz. We expect it to consolidate, as the news flow going forward will likely be more ambivalent for risk assets. We would continue to maintain a 5% allocation to gold, as geopolitical tensions are likely to linger on to some degree, real interest rates are expected to decline, the US dollar is forecast to weaken, and central bank buying remains strong.

**Sell AUD-downside risks on overly-dovish RBA expectations.** As an oversold laggard, the AUDUSD had ridden the returning wave of risk appetite, but then managed to avoid getting swept back out with the overall USD. The surprise dovishness from the RBA's latest monetary policy meeting though, might generate dips in the near term. Although the RBA's 25bps cut was expected, the distinct departure from its longstanding hawkish bias was not. This has seen the market turn excessively net-short AUD and overly dovish on expectations of RBA policy. We expect one more 25bps rate cut in each of August and November—a total of 50bps for the next 12 months, and a terminal rate of 3.35%. This contrasts with the 3% terminal rate markets are pricing in for the RBA. Further out, we expect the US Federal Reserve to start cutting rates in September for a total of 100bps through 1Q26. Selling AUDUSD downside risk to 0.63 not only generates yield in the meantime, but also facilitates conversion of USDs to AUDs at a more attractive rate.

**USD dips and HKD loans.** Although the USDHKD is a pegged rate, there is actually a narrow tradable band of 7.75-7.85 in which the pair is allowed to trade. The boundaries of this band are maintained by HKMA, which is very well equipped to defend those bounds. As a matter of policy, this hybrid "currency board" arrangement is still very well-suited to Hong Kong's economic and political needs, and it thus has the backing of both mainland China and Hong Kong policymakers.

This hybrid arrangement makes the HKD a popular funding currency when a sizable gap between HKD and USD interest rates opens up, especially when the USDHKD is also close to the floor (strong-HKD) end of the trading band. The USDHKD at the lower bound of 7.75 (for example) would make borrowing in HKD for a USD investment relatively safe against FX losses, plus additional savings from the interest-rate differential. Such conditions can make using the HKD as the funding currency for real asset purchases attractive, and this has often been observed. The USDHKD spent about a week in early May essentially at 7.75 after the USDTWD fell 8.4% in two sessions. Aside for the Covid lockdown of 2020, USDHKD dips below even 7.70 have been rare and fleeting. The Trump administration's propensity for policy disruptions though might make it worthwhile being alert to such recurrences.

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