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MACRO MORNING BRIEFING

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Dollar Downside Limited By Lack Of Alternatives

Rates Path, Twin Deficits Argue for Lower Dollar, but Against What?

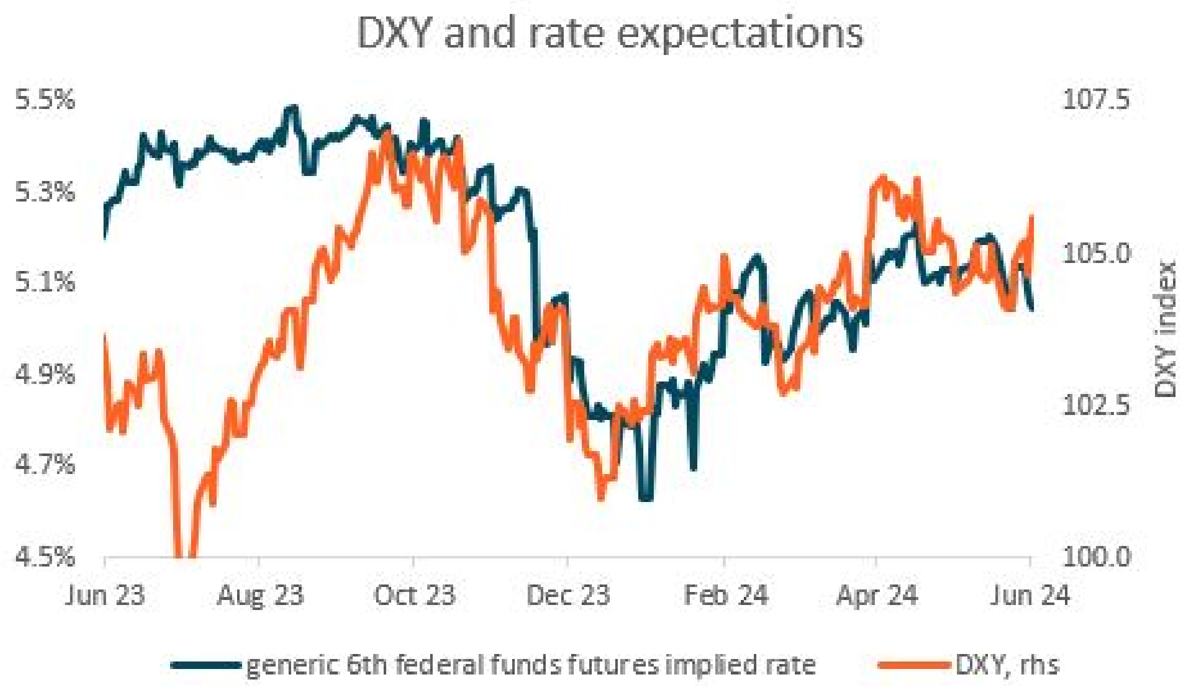
- A September Fed rate cut should weaken the greenback
- However, a lack of alternatives to buy should limit downside
- Dollar holdings are ambivalent
- Twin deficits a longer-term concern

What's next for the broad US dollar? Some G7 central banks (European Central Bank, Bank of Canada) have already started cutting policy rates, although it's unclear how quickly or deep future reductions will be. The path of the Federal Reserve's monetary policy is still uncertain – even after last week's FOMC (our review). In addition, there are questions about the US's economic cycle – especially relative to other major economies. The US also faces a daunting twin deficit, both fiscal and on the current account, well into the future. In this piece we take a look at some of the major short-, medium-, and longer-term drivers of the Big Dollar. We conclude that a slightly weaker dollar is to be expected, but with limited downside.

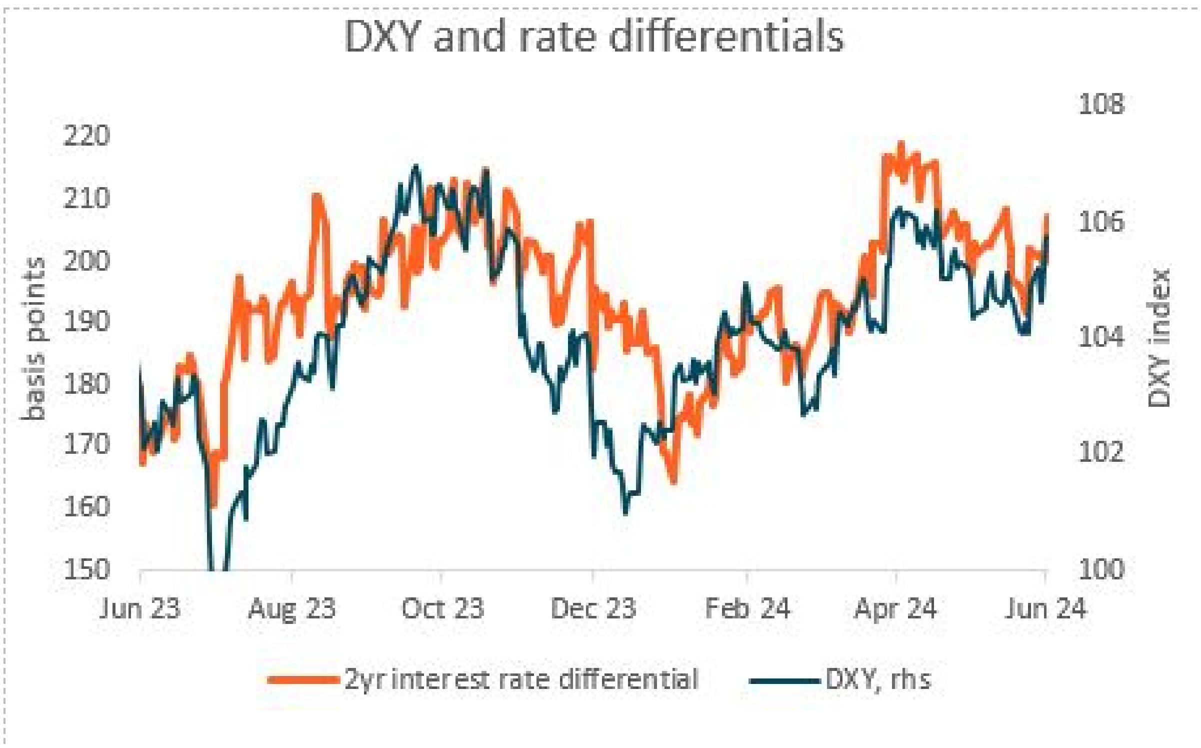
Among the short-term drivers, interest rates and their cousins – policy expectations – have been important and undeniably well-suited to explain recent USD movements. In the first of the two charts below, we plot the generic 6th federal funds futures implied policy rate against recent levels of the US Dollar Index (DXY). Since the end of last year, the two series have followed one another closely – a view on the Fed is a view on short-term dollar movements.

This dynamic is robust, and it can be confirmed in cross section. In the second chart below, we plot the spread between the weighted average (according to their weights in the index) of the 2y yields of the currencies in the DXY basket versus US 2y yields. The relationship is clear. To the degree that 2y yields are a good medium-term measure of policy rate expectations, the broad dollar is strongly dependent on these interest rate differentials.

Policy Expectations & Yield Differentials Matter



Source: BNY Markets, Bloomberg



Source: BNY Markets, Bloomberg

To be sure, the results implied by the preceding two charts are not by themselves prescriptive. As noted above, it depends on the course of monetary policy in the US and peers, specifically, how much policy divergence one can expect between the Fed and other monetary authorities. Despite last week's FOMC, which indicated that the collective median of members' end-2024 projections for the funds rate foresaw just one cut, we still believe that September will bring the initial rate reduction of a cycle. Implied probabilities for a cut then are now around 65%. Compare this to the end-April probability of just 30% (or the end-May probability of 40%) and momentum for a move in September is growing.

Does this mean the dollar will weaken over the summer if this momentum builds? We would normally argue in the affirmative, but there remains the question of what other central banks are going to do. One problem is that we don't see too many candidate currencies for the other side of a weaker dollar trade – certainly not in the G7. We maintain a negative view on the euro and sterling is an enigma, at least until the other side of the July 4 general election.

With the Bank of Japan poised to raise rates and/or rapidly reduce Japanese government bond purchases this summer, we might be inclined to think that the yen is a good candidate to appreciate against the dollar. However, current market pricing sees all of a 5bp increase in the BoJ's target rate, not enough in our view to fundamentally change the picture.

We maintain a rather negative outlook for the Canadian dollar, given our view that the BoC will likely be able to lower rates faster than the Fed this year. We expect a second cut in the BoC's overnight rate in September, and possibly two more (at least one) this year. We thus think USDCAD could creep towards 1.40 from its current 1.37 handle. However, we do see scope for CAD to weaken more against some of its non-dollar crosses. The chart below shows the BoC's own estimates of the effective Canadian dollar, both including the USD (blue line) and excluding the USD (orange line). The former is range bound and compared to the latter, which is much more fully valued, its downside appears limited. The effective CAD rate ex USD has room to depreciate, so most of our negative CAD view would be better expressed against other major trade partners' currencies.

CAD Can Weaken vs. Non-USD Crosses

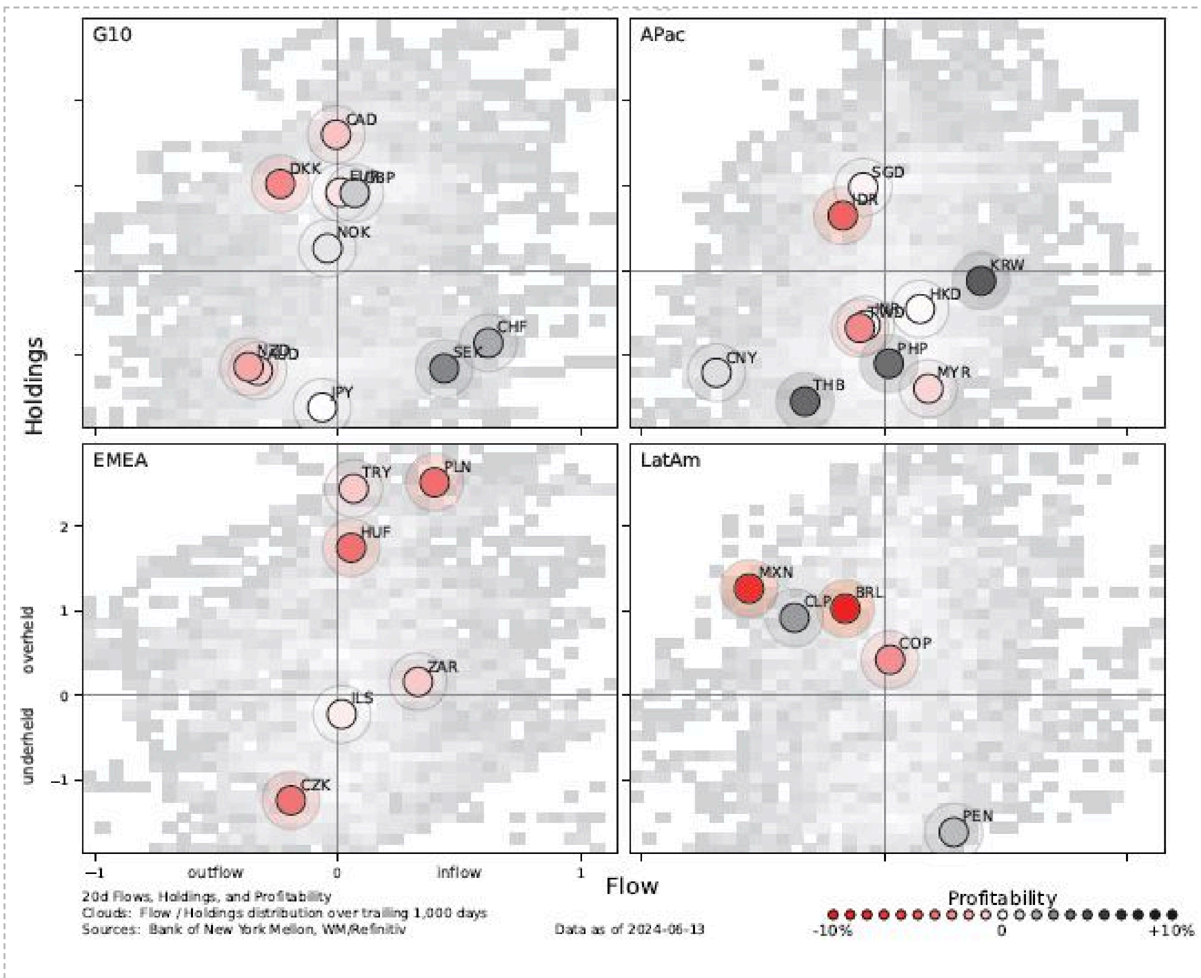
Source: BNY Markets, Bank of Canada

Turning to our own data, iFlow reports trade-weighted USD holdings, as shown below. Dollar positioning is nearly neutral, having come up from quite low levels at the end of 2023. Much of those earlier underweights were due to heavily extended MXN holdings, those the result of both the carry trade and – at the time – generally favorable medium- to long-term views on Mexico fundamentals. A minor reversal of the carry trade, especially in LatAm, as well as policy concerns in Mexico after the sweeping electoral victory of President-elect Scheinbaum, have since eroded MXN attractiveness. As shown in the latest iFlow Cloud chart (second below), which depicts flows, holdings, and profitability for the nearly 40 currencies we track in iFlow, MXN positions are not nearly as extended as they were six months ago. Flows are negative and MXN positioning is now quite unprofitable. In short, MXN positioning is now neither a positive nor a negative for the broad USD.

USD Holdings Nearly Neutral

Source: BNY Markets, iFlow

iFlow Cloud



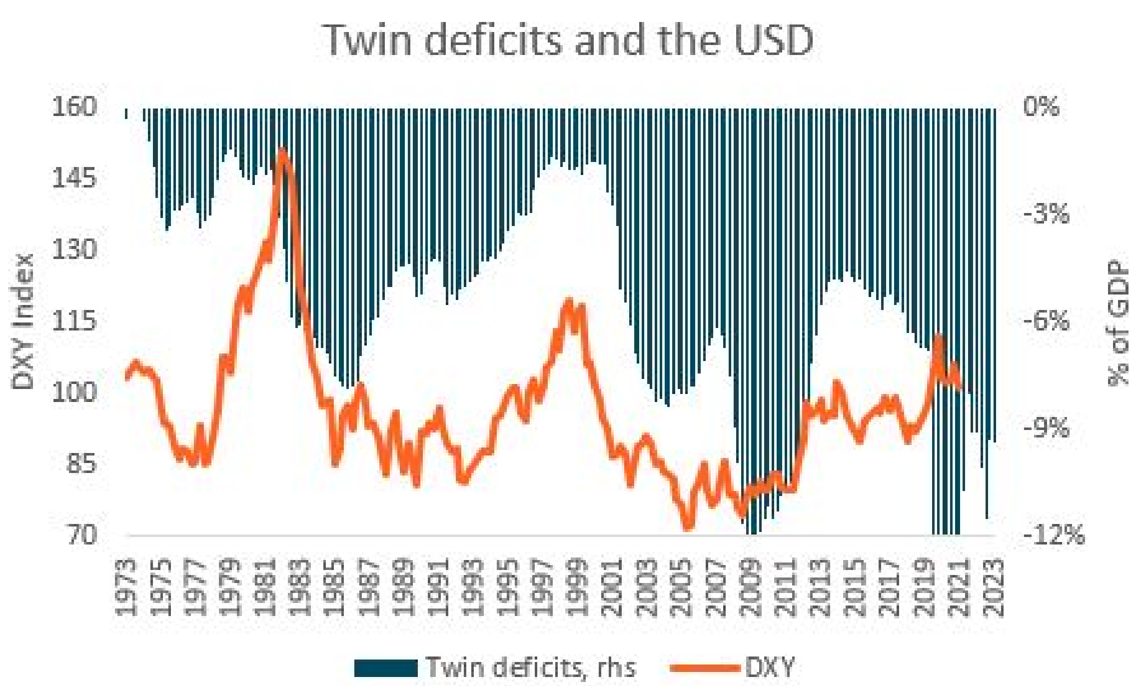
Source: BNY Markets, iFlow

Finally, we examine an important medium- to long-term fundamental for the dollar, the so-called “twin deficits.” The combination of the US's fiscal and current accounts is currently deeply negative. In the chart below, we plot the sum of these two macro variables from 1973 through the end of 2023 against the lagged (by one year) levels of the DXY. There is a clear relationship between the twin deficits and the dollar, but it takes a few years to manifest.

Currently, the sum of the fiscal deficit (approximately 6.5% of GDP) and the current account balance (-3% of GDP) is nearly 10%. This is not the worst observed twin deficits over the past 40 years, but close to it. Our view is that neither deficit (fiscal or current account) is likely to narrow in coming years, suggesting that over time and independent from monetary policy expectations, the general direction of the USD should be lower.

So, back to the question we initially posed above – where is the dollar going? Longer term, we see a weakening of the greenback thanks to the lack of improvement in the twin deficits. Over the next few months, if we’re right that September will bring the first US rate cut, we would also expect some depreciation in the currency. However, a lack of really attractive alternatives in the short term will likely limit dollar downside.

Twin Deficits A Medium-Term Concern



Source: BNY Markets, Bloomberg

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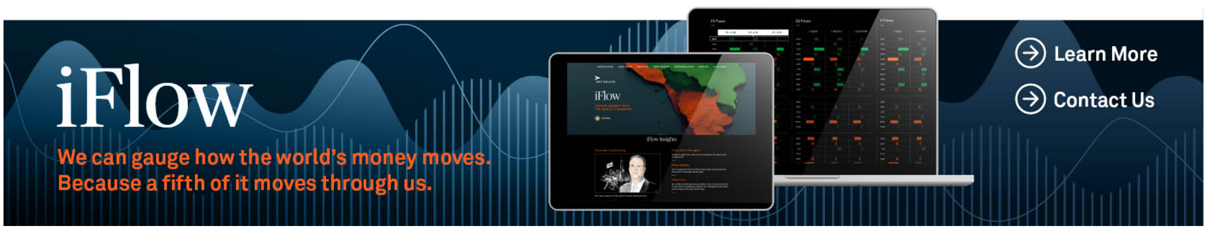

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