Scotiabank™
Global FX Strategy

FX SNAPSHOT
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King Dollar—For Now

We recently revised out USD forecasts to reflect the expectation of a little more USD strength overall in H2 this year before it retreats in 2023. We think there are still clear grounds for caution on the potential for the USD to weaken significantly in the short run, even if it does appear as if the Fed rate tightening cycle is nearer a peak and the USD's growth advantage story looks frail after a second, negative GDP report. Yield spreads may not widen much further in the USD's favour from here but a significant compression is unlikely; policy makers in Europe are constrained in terms of how much more policy tightening can be introduced in the next few months and there is clearly no imminent shift in BoJ monetary settings. Geo-political challenges remain, particularly for the Eurozone, given the risk of a severe, potentially recession-inducing reduction in Russian natural gas supplies over the winter as the Ukraine war rumbles on. To a large extent, the USD, despite emerging challenges at home, wins by default as the "least dirty shirt" among the major currencies still.

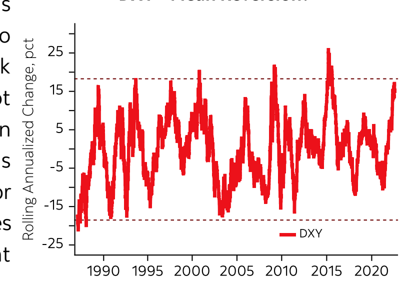
That does not, however, mean that we think the USD can continue to power ever higher. We had thought that the USD bull cycle was peaking in May but that was clearly premature. Transitions from bull to bear cycles are typically choppy—and drawn out—affairs for the USD and what we are seeing is perhaps a manifestation of that. And beyond the fundamental arguments for and against the USD currently, we note that;

- Since 1987, bearish phases in the DXY consistently run out of momentum as annual losses near 18%. Bullish cycles typically peak between rolling annual gains of 18-25%. At its recent peak in mid July, the rolling annual gain in the DXY touched 17.5%.
- The DXY is trading near the 95th percentile of the post-1987 range (94th currently, to be precise).
- The DXY is trading 1 standard deviation above its 10Y moving average, close to where bear and bull phases have reversed in the past 10 years.

These factors in and of themselves are not necessarily negative signals for the USD. But, at the very least, the statistics do suggest that the USD rally is looking quite extended and that additional gains—without strong motivation—may be harder to achieve. Equally though, significant USD losses look unlikely while relatively high US interest rates make outright USD shorts an expensive proposition, absent a strong, fundamental catalyst that would prompt expectations of a rapid decline.

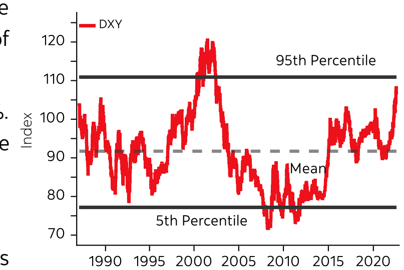
If investors do conclude the USD bull run is long in the tooth, a reduction in bullish positioning, resulting in a steady erosion in its performance against the likes of the JPY and EUR which have borne the brunt of the long USD positioning campaign in recent months, could ensue. But this is likely to be a relatively slow-burn affair which serves to cap the USD rather than drive it significantly lower.

DXY - Mean Reversion?

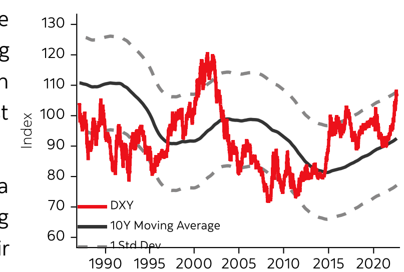


Source: Macrobond, Scotiabank FICC Strategy

DXY Nearing 95th Percentile of Range



DXY is 1SD Above 10y Average



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