Positioning and Market Sentiment Pull Dollar Away from Fundamentals

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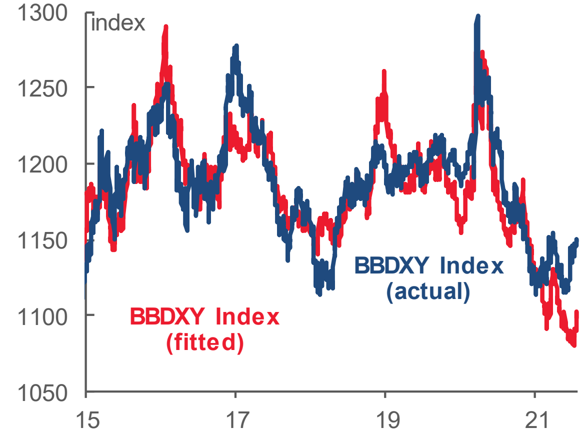
Over the past six weeks, the USD has strengthened from its lowest levels since early-2018 to close in on a year-to-date high that has seemingly halted the downward pressure building since the Q1-2020 corona-virus shock. Our fair-value estimate of the Bloomberg Dollar Index (BBDXY)—comprised of a basket of ten currencies weighed by international trade volumes and FX liquidity—points to an over-valuation in the dollar of around 5%, however. The 'deviation' in the dollar versus our fair-value model is at its widest since the creation of the BBDXY in 2005 (though down from 5.8% in early-July) and suggests that further dollar gains in the short run will be hard to come by unless financial conditions and commodity prices deteriorate further.

We think dollar bears may be withdrawing their bets on a weaker dollar after it failed to extend its losses through May and June, bottoming out around the same point as early-January. A move beyond the late-March high in the BBDXY would confirm that the USD is gearing up for a strong reversal of its losses since March 2021 from a technical perspective. While we think that on the basis of fundamental drivers the dollar is currently overvalued—and the greenback's gains look particularly stretched against the likes of the CAD, for instance, given rate differentials and current commodity prices—markets may maintain the dollar at relatively elevated levels with Fed rate hikes on the horizon. A correction in the USD may prove only short-lived and modest if the Fed begins to tee up rate hikes as early as the second half of 2022.

On the other hand, we currently think the dollar will not strengthen significantly as relatively low yields blunt its attractiveness while global risk sentiment and commodity prices are likely to improve once the spread of the delta coronavirus variant is brought under control. Daily deaths in India, for example, have fallen to their lowest mark since early-April and we remain hopeful that vaccines will provide sufficient protection in those countries with high immunization rates that are now seeing a steep increase in cases—such as the UK, Spain, and parts of the US. While technical factors and an eventual surfacing of Fed hikes on the horizon support the view of a stronger dollar in the medium-term, the rates and sentiment picture suggests that the USD will remain subdued into year-end.

Bloomberg Dollar Index Fair-Value Model



Source: Bloomberg, Scotiabank FICC Strategy.

Our daily BBDXY model is comprised of financial variables and sets aside longer-run (and lower frequency) macro-determinants typical of other currency models such as trade and fiscal imbalances as well as growth differentials between the US and other countries that would increase or decrease the appeal of the dollar. In a way, however, the performance of the financial variables selected stand as proxy for macroeconomic conditions and expectations—US rates outperform German rates when people anticipate the Fed tightening ahead of and faster than the ECB as the US economy closes the output gap faster. We include the spread of US 5-year notes against their Canadian and German counterparts, 12-mth WTI oil futures, Bloomberg's industrial metals prices index, US dollar index (DXY) net positioning (weekly), and Mexican 5-yr CDS prices. The first two capture the relative yield appeal of the dollar against the CAD and EUR and reflect relative monetary policy to a degree (we've left out spreads against JGBs as they provide little additional explanatory value). Commodity prices capture trade balance fluctuations, positioning reflects speculative sentiment, and Mexican CDS are used as a proxy for the risk tone in markets. We estimate this over a daily frequency starting in January 2006 to present. The model has an adjusted R^2 of 0.96 and all variables are statistically significant at a 5% level.