Scotiabank™
Global FX Strategy

FX SNAPSHOT
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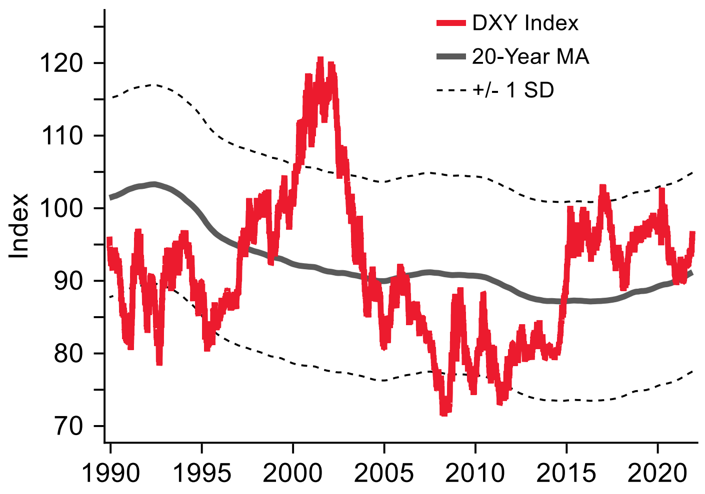
Dollar Gains May Extend and Persist for Longer

In a note last week, we highlighted the short/medium term potential for the USD's rise to extend in broad terms. Seasonal USD strength in November is developing much as we expected and strong economic data continue to hone the market's expectation that Fed policy adjustments may come through more quickly than most had expected (and some market participants still expect). We highlighted the risk of some chop around year end but we estimated scope for additional gains of around 3-4% from the 94.50 area (which would take the DXY to 97/98).

USD Index Could Rise to 104/105



Source: Macrobond, Scotiabank FICC Strategy

It is perhaps worth considering longer run risks for the USD (i.e. beyond the next few quarters). Our formal forecasts reflect the view that the USD rally should start to show signs of peaking in H2 2022, when other central banks are at least starting to think about raising interest rates and the Fed tightening cycle should be well underway and perhaps somewhat discounted in markets.

While we think markets are buying into the risk of an earlier start to the Fed tightening cycle in a meaningful way, the risk of a later start to the ECB, SNB and BoJ tightening measures—and perhaps a delayed start of tightening from the BoE—is not perhaps fully factored in to the USD at this point. ECB officials are stressing 'patience' on the policy front and expect price pressures to be transitory; the pressure that the ECB has faced to perhaps raise rates in 2022 should also fade as the easing transitory and year-ago effects fade and see inflation eventually fall under 2%. The BoJ has little hope of reaching its inflation target over the foreseeable future; prices only rose by 0.1% y/y in October. The Fed—and the BoC—by contrast are clearly moving to adjust policy settings relatively quickly. The yield and growth advantage for the US and Canada could become quite a bit starker than we have been anticipating over the next couple of years which may mean there is scope for additional USD (and CAD) gains versus the rest of the G10. And even in the short run, weakened risk sentiment around new COVID-19 waves, and military tensions in Eastern Europe and East Asia should help keep the USD bid for its haven status.

Medium to longer run (i.e. 1-2 years out) risks may well be tilting towards the DXY extending this rally towards 104/105. The 20Y moving average for the index has been instructive in terms of setting the broader direction for the dollar generally (better bid above the 20Y moving average and better offered below it) for the past 30 years. A one standard deviation band has provided some rough parameters for the extent of the USD over/undershoot relative to this benchmark. This may mean that DXY gains could extend towards the 104/105 zone moving forward (about 8% above current levels).