Sucden Financial

FX Monthly Report- The Dollar

September 2024

FX Monthly Report

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Dollar Focus

Economic Impact

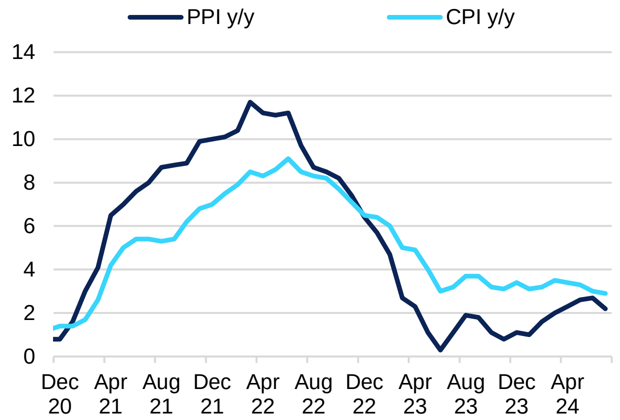
Throughout much of this year, the dollar has maintained its status as one of the strongest currencies globally, gaining as much as 5.5% in the first half of the year. Delayed expectations regarding the start of the Fed's interest rate-cutting cycle meant that the US yield differential with the rest of the world remained elevated, causing capital outflows elsewhere.

As the year progressed, the expected number of cuts decreased from 7 to 2, as the economy did not display signs of slowing down. Key indicators, such as price growth and labour data, remained high, indicating that the economy remained robust despite elevated financing rates.

Inflation remained stubbornly high as various sectors of the economy experienced price growth at different times. In July, US CPI rose by 2.9% YoY, with a 0.2% MoM growth, suggesting that overall inflation is abating. However, service inflation remains sticky at 4.9%, driven largely by rising labour costs. Therefore, while recent inflation prints are encouraging the start of the cutting cycle, historical patterns suggest that inflation is likely to remain elevated in the medium to long term.

US CPI and PPI

While US CPI is softening at a steady rate, PPI is accelerating.



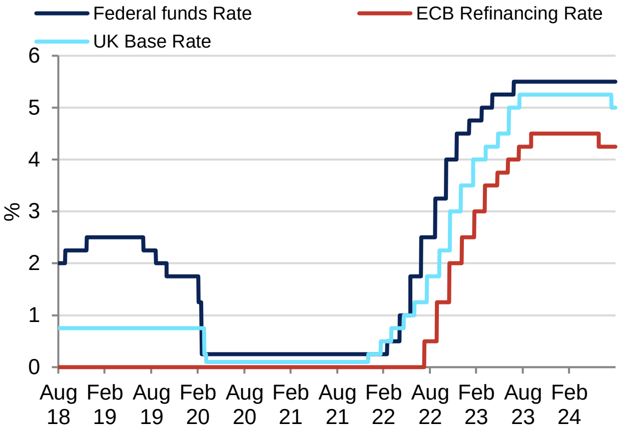
Source: Bureau of Labour Statistics

In August, market sentiment shifted as bets on the Fed's first interest rate cut in September accelerated. This change in outlook was driven by heightened recessionary fears earlier in the month, leading to a significant adjustment in US-related assets. The greenback was no exception. Experiencing a rapid sell-off, it surrendered this year's accrued gains within the first week of August, prompting the dollar index to break below the 101 mark - the lowest level in over a year. Although these fears later proved to be overblown and market sentiment eventually calmed, the dollar's decline persisted. Investor attention turned towards Jerome Powell's speech in Jackson Hole, where the Fed Chair reaffirmed market beliefs and indicated that a start of the monetary policy-cutting cycle is expected in the near term. As of now, forward swaps expect 33bps worth of cuts at the September meeting, which will take place on September 18th.

With a few days left until the Fed's next meeting, what should we anticipate for the dollar in the near term? Considering our projection of two 25bp cuts in September and December, along with a highly dovish market sentiment regarding the extent of the Fed's cuts (100 basis points by the year-end), we anticipate that the downward momentum which pushed the dollar index to 101 will ease in the near term. We expect the market to adjust its expectations to be less dovish in the coming months.

US, EU, and UK Interest Rates

Even with a 25bps cut from the US, the yield differential with UK and Europe remains.



Source: Bloomberg

Based on the overall view of the US economy, we believe there is a strong likelihood of a soft landing. Core inflation is easing steadily; however, food and service inflation components remain upwardly sticky, leaving little room for the Fed to make significant cuts in the coming quarters. While labour data is softening month by month, conditions remain historically tight. Therefore, we expect the Fed to implement cuts in a slow and steady manner, with one to two 25bps cuts per quarter going into 2025, provided that the economy continues to remain robust. This should maintain the yield differential with more economically vulnerable economies, which may be prone to make aggressive cuts later on in the year. This should help sustain the dollar above the 99.50-100.50 level.

As we head into the fourth quarter, the US monetary policy outlook won't be the only driving force behind the dollar's performance. A number of major central banks are about to start or implement cuts in their interest rates. The relative yield differential between the Fed and other major economies will determine the dollar's trajectory. Of particular interest is the Eurozone, where the ECB has already made one cut in June and is anticipated to cut rates by 50 basis points by year-end. Any potential delays in this cycle could prompt the markets to adjust their expectations concerning the EUR/US yield differential, thus weakening the dollar further. The relative yield performance will also influence the carry trade's momentum, especially given the growing expectations for a rate cut from the Fed. This shift could make currencies from emerging nations, which have been negatively impacted by high US interest rates, more appealing.

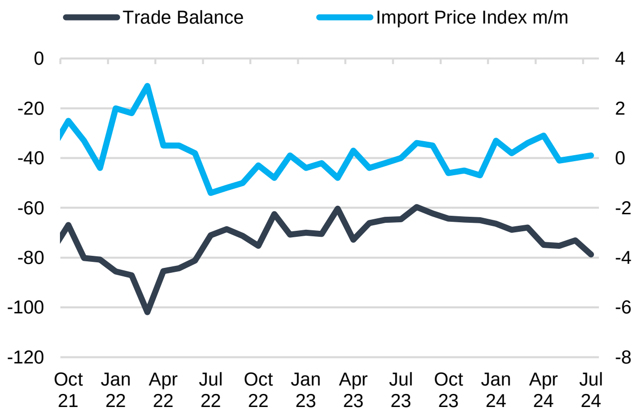
US Election Impact

Looking ahead, the November elections introduce an additional layer of uncertainty for the dollar's trajectory. As the election draws closer, market participants will likely begin to price in the potential economic policies of the two leading candidates, Donald Trump and Kamala Harris. While both candidates share similar views on trade protectionism and a cautious stance towards China, their broader economic agendas could lead to different outcomes for the dollar. Historically, election periods are marked by heightened market volatility, as investors adjust their positions in response to shifting polls and campaign developments. Expectations around future policies, particularly those related to fiscal spending, trade, and regulation, will be crucial in shaping the dollar's movements during this period. As a result, we may see increased fluctuations in the dollar as markets anticipate the impacts of either candidate's economic strategy.

Implications of Harris's Win: Kamala Harris currently holds a slight lead in the polls, with 47% of voters favouring her candidacy. Her economic proposals include tax credits for families and first-time homebuyers, as well as initiatives to regulate consumer prices. These policies could have mixed effects on the dollar. Increased government spending, without corresponding revenue increases, could lead to larger budget deficits, potentially raising concerns about inflation and debt, which might weaken the dollar if investors view these factors as increasing economic risk. Additionally, Harris's relatively unexpected rise as the Democratic candidate introduces uncertainty regarding her policy implementation, which could further contribute to dollar weakness. However, if Harris successfully implements her proposed tax credits and consumer support measures, this could eventually stabilise economic growth and provide a more favourable outlook for the dollar. In the short term, however, the uncertainty surrounding her potential presidency, and the immediate impact of increased government spending and market interventions are likely to exert downward pressure on the dollar.

US Trade Balance vs Import Price Index m/m

In July, a surge in imports pushed up the trade deficit to the widest since June 2022.



Source: US Census Bureau, Bureau of Labour Statistics

Implications of Trump's Win: If Donald Trump wins the election, his past economic policies suggest the potential for a two-phase impact on the dollar. During his previous presidency, Trump enacted substantial tax cuts, deregulation, and increased government spending, which stimulated economic growth and supported a stronger dollar as investors anticipated higher returns from US assets. However, his administration's aggressive trade policies, including tariffs on China and other major trading partners, introduced significant global uncertainty, leading to fluctuations in the dollar's value. Trump's frequent criticism of the Federal Reserve and his push for lower interest rates to weaken the dollar and boost US exports also contributed to market volatility, as these actions often conflicted with the Fed's independent monetary policy decisions.

If re-elected, we expect a similar pattern: an initial appreciation of the dollar driven by expectations of continued pro-growth policies, such as tax cuts and deregulation. However, this strength might be short-lived as market participants anticipate renewed trade tensions, potential tariff escalations, and Trump's inclination to push for a weaker dollar. This could lead to increased market volatility and a possible decline in the dollar's value as investors react to the dual pressures of economic stimulus and trade protectionism. Ultimately, while a Trump victory might initially boost the dollar, the medium-term outlook could see a reversal if his policies lead to economic uncertainty and inflationary pressures.

Desk Comments

GBP

GBP continues to trade higher against most G10 currencies as data continues to surprise to the upside and the rate of interest rate cuts lags behind other G10 economies. Another 42 bps of cuts are priced in by year end in the UK in comparison to 62 bps in the eurozone and 103 bps in the US.

The UK continues to see inflation fall. CPI falling to 2.2%y/y. UK shop prices also fell for the first time in almost 3 years, down 0.3% y/y. BOE governor Andrew Bailey said it's "too early to declare victory" over inflation but the risks of persistent inflation have receded paving the way for further cuts.

GBPUSD is likely to be driven by US data in the near term, while we still look to sell EURGBP on rallies. We continue to see EURGBP trend lower with 0.82 now being the medium term target.

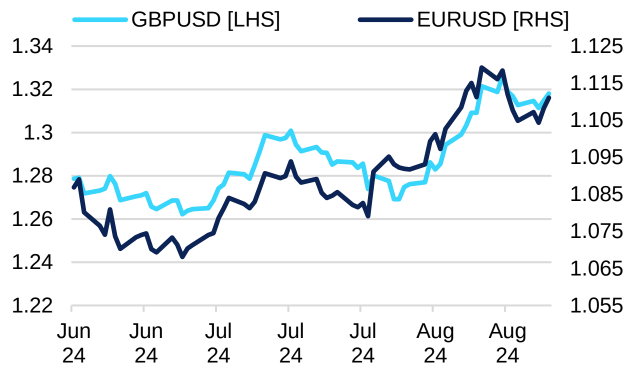
Retail sales and consumer spending saw an increase in August due to the warmer weather. The rise in spending and latest set of economic data demonstrates the UK economy has proved more resilient than expected this year thus we expect the momentum to continue in Q3.

EUR

The EUR surged more than 3% against the USD this quarter, as the Fed inches closer to its first rate cut of the cycle. However, political uncertainty in France persists as Macron nears his decision on whom to appoint as the new prime minister. Until Macron's newly appointed PM has, firstly, avoided losing a vote of no confidence and, secondly, laid out plans for the country's monetary budget in October, France's political uncertainty will remain. In addition, recent political polls in Germany point towards the EUR-sceptic Alternative for Germany (AfD) party, which sits on the right of the political spectrum, being on course to win a clear victory in the Thuringia state election, with reports suggesting they may also emerge second in Saxony. These evolving political scenarios have increased political risk within the Eurozone, potentially overshadowing the EUR's recent gains against the USD and leading to a more moderate month ahead for EUR strength.

GBP and EUR vs the Dollar

EURUSD has been gaining momentum in recent weeks.



Source: Bloomberg

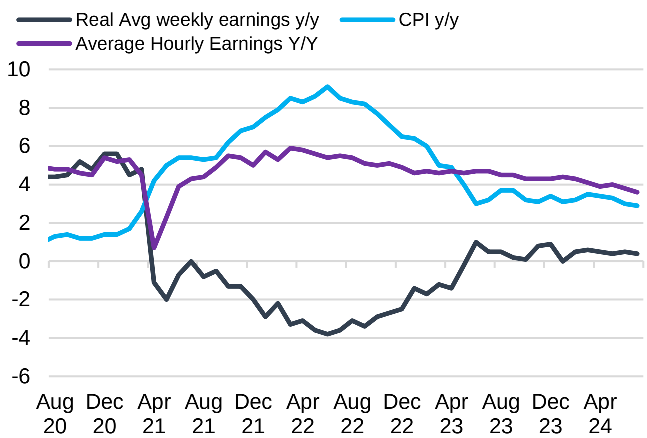
In the Eurozone the inflation picture remains more enigmatic than in the US, with domestic driven inflation remaining above the ECBs tolerance level. Broad inflation is still heading towards the 2% target with most recent Eurozone annual inflation level falling to 2.2% supporting the ECBs gradual 25 bp quarterly rate cut process to continue in September. Furthermore, the ECBs Schnabel has urged caution regarding the continuation of the rate cuts due to sticky core inflation (2.9% y/y similar to July) driven by persistent service costs further supporting the idea that a gradual 25bp/quarter approach for the ECBs rate cuts should be continued into the next year in order to reach the policy rate of 2.50% by the end of 2025.

USD

The USD has been trending lower in H2 but momentum accelerated last month due to election uncertainty and Powell comments at Jackson Hole on the progress of fighting inflation. His comments opened the debate on how much, not if the FED will cut rates this month. The market is currently pricing 35 bp of cuts. His words sent yields lower and stocks higher as risk sentiment improved. The recent strength in the JPY and perceived lower rates in USD establishes the USD as a potentially appealing currency to fund carry trades. The USD traded at the weakest levels of the year. DXY hit fresh lows at 100.50, if vols remain at low levels we see further downside potential in the USD.

US Wages vs CPI

Inflation, and in turn, real average income remains sticky.



Source: Bureau of Labour Statistics

The speed of cuts may depend largely on upcoming labour data. Unemployment levels have risen but not due to extended layoffs but rather the increased supply in the labour force due to immigration which makes it less of a trigger for a recession. The FED has only cut by 50bp when the US is heading into a recession, so the current set of data suggests this isn't on the horizon and a 25bp cut is more likely.

Looking ahead, we anticipate divergence in how the USD will trade in the near term, rather than exhibiting uniform strength or weakness against a basket of currencies. We expect positive data to weaken the USD against higher-beta FX currencies, while showing marginal outperformance against low-yielding currencies.

Our Outlook

Our View: We expect the downward trend in the dollar will slow in the coming weeks, with the 100 support level remaining strong. Although the index might dip slightly below this level, we do not anticipate a major decline below it. Following the 25bps cut in September, we expect the market to adjust its expectations for a more moderate cutting cycle going forward, bringing the dollar index to a more neutral position at 103-104. For the dollar to weaken further, a recession needs to be priced in, which is not something we anticipate. Moreover, with the US Election in November, dollar volatility is likely to increase.

Technical Analysis

GBPUSD

GBPUSD has surpassed the upper boundary of the symmetrical triangle, which had constrained price movements throughout the current year. The breakout above the 1.30–1.3035 range, as well as last year's high of 1.3142 (July 2023), suggests the potential for further upward momentum toward the channel resistance at 1.3650. The previous resistance zone between 1.30 and 1.3050 is expected to offer initial support. Should this support level be breached, prior support levels within the symmetrical triangle may come back into focus, including the 1.28–1.2830 range (formerly a resistance zone), and ultimately the lower boundary of the triangle at 1.2480.

EURUSD

EURUSD broke above the wedge formation after Powells comments at Jackson Hole which saw USD sell off aggressively. EURUSD traded to 1.12 breaking resistance at 1.10 (2024 highs) and 1.1135 resistance. Looking at longer (weekly) chart, EURUSD remains in a range with 1.1274 (previous high, 61.8% retracement) acting as resistance. A break below 1.10 open ups cluster support at 1.0650 -1.07.

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