USD Outlook

MONEX

January 2022

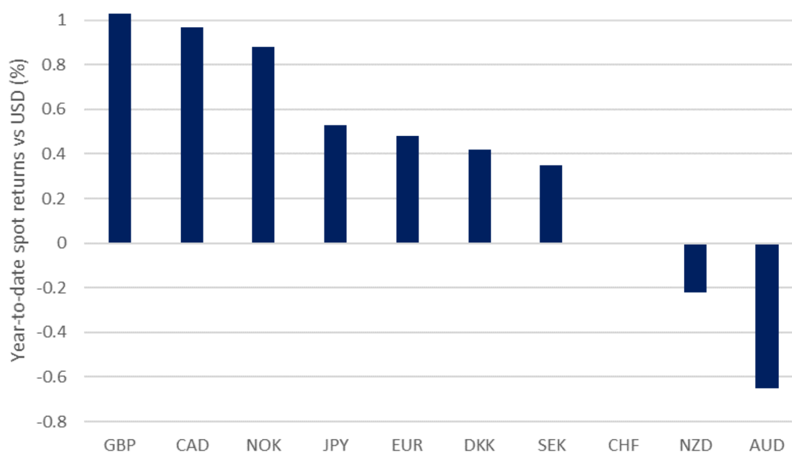
USD outlook: factoring in the stall in hawkish Fed pricing

Author

Simon Harvey
Senior FX Market Analyst
+44 (0)203 650 6472
Simon.Harvey@monexeurope.com

Since the Fed's hawkish turn at December's meeting, yields on the 2-year US Treasury have jumped over 25bps to sit just shy of the 1% mark at 0.9%, while the 10-year has risen nearly 30bps to trade at 1.75%. Despite the rise in US yields and the slight wobble in US equity markets as rotation into value stocks took place, FX markets have only have been relatively ignorant to the shift in market pricing of the Fed. That is, until the rise in US yields and short-term interest rates stalled, leading to the broad decline in the dollar following December's CPI release. Since the December meeting, the DXY index has fallen by 1.5% meeting, the DXY index has fallen by 1.5% despite data released over the same timeframe for December showing the unemployment rate falling below 4% and inflation data rising to a near 40-year high.

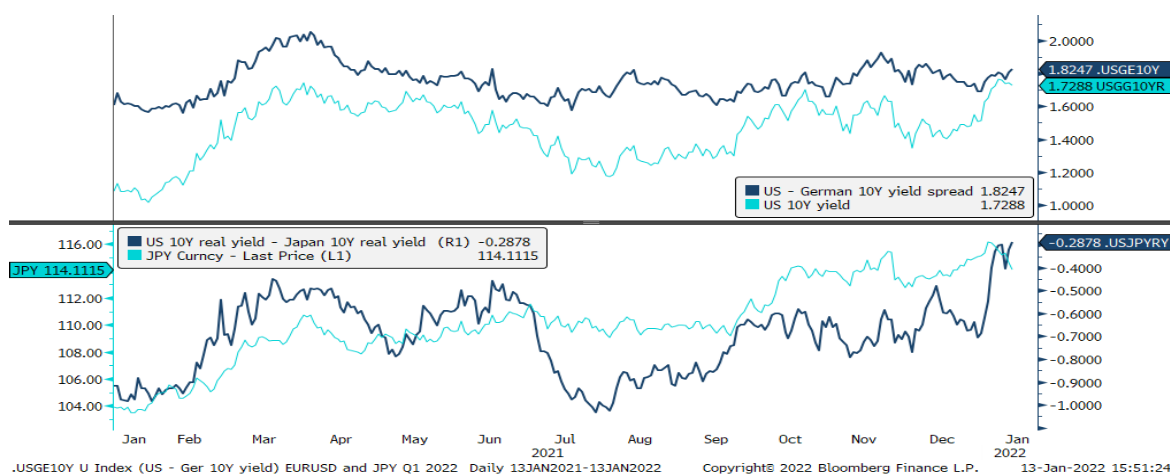
G10 year-to-date spot returns against the US dollar in %



In our January forecasts, we viewed market pricing of the Fed's rate path as broadly consistent with our views. That is, 3 confirmed rate hikes in 2022 with a risk of a fourth and quantitative tightening in H2. We assumed the data would confirm this, which it has done to date, and that it would result in tight ranges in EURUSD and USDJPY due to the sensitivity of both currency pairs to US yields. Owing to the DXY's composition weights, we expected this would leave the DXY index elevated despite our expectation of dollar weakness against most other G10 currencies. However, FX markets haven't followed our expectations entirely, with the dollar declining despite Treasury yields rising. This can be explained by a few factors.

Firstly, eurozone bond yields have largely kept pace with the move in 10-year Treasury yields, which have stalled at the 1.8% level and continue to trade at a substantial discount to the Fed's neutral rate estimate of 2.5%. Secondly, global risk appetite has improved since the turn of the year as concerns over the impact of Omicron fade. Coupled with an improved near-term growth outlook, the improvement in risk appetite has not only helped procyclical currencies but has also aided the rise in back-end eurozone bond yields, with the 10-year bund threatening to trade in positive territory. While we flagged this risk in our January forecasts, we didn't expect it to materialise until year-end once the ECB started to wind down their large presence in eurozone bond markets. Hence, we preserved our view that the single currency would fluctuate around a mean value of 1.13 against the dollar before the formal arrival of the Fed's hiking cycle in March placed further pressure on the currency pair. For JPY, the stalling nature of US 10-year yields around the 1.8% level has resulted in narrower 10-year inflation indexed bond spreads from stabilising. Coupled with Covid risk in the APAC region and broad USD weakness, JPY has followed the G10 higher against the dollar since the turn of the year to trade nearly 2% higher from multi-decade lows recorded at the start of the year.

US-German spreads remain fairly stable despite sharp rise in the US 10-year while stabilisation in 10Y real yield spreads between the US and Japan help alleviate pressure on JPY



Looking ahead, events since the publication of our January forecasts, notably December's meeting minutes, CPI release and nonfarms data have resulted in us moderately shifting the timing of our Fed calls and the likely sequencing of policy normalisation.

> **We now expect the Fed to hike rates in March, with further hikes of 25bps increments likely to follow in both Q2 and Q3,** as policymakers look to get in front of any potential unanchoring of inflation expectations and broadening of inflation pressures given the record high headline prints.

However, a further rate hike in Q4 remains clouded in uncertainty and largely hinges on the potential increase in labour market supply following a lengthy period of elevated wage growth and the level of disinflation in the economy. Additionally, we now expect the Fed to embark on a level of quantitative tightening in H2 that broadly follows the dynamics of the previous QT cycle.

That is, following a series of 2-3 rate hikes, the Fed will allow maturing assets to roll off its balance sheet at a maximum monthly rate at a speed that is likely double the $60bn per month seen at the peak of the last QT period. In relation to market pricing, we think the risks are tilted towards the Fed underdelivering and resulting in further USD downside.

For FX markets, we think **USD downside has largely run its course** for now ahead of January's Fed meeting and believe a consolidation is the likeliest next phase.

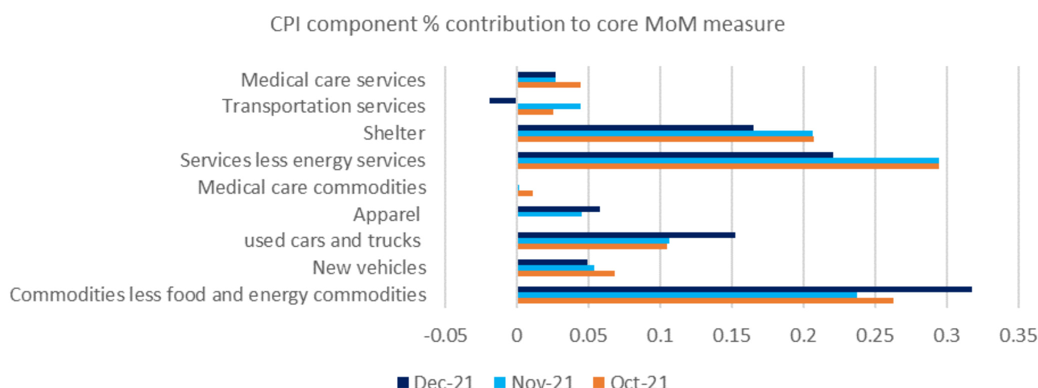
Monex's January forecasts

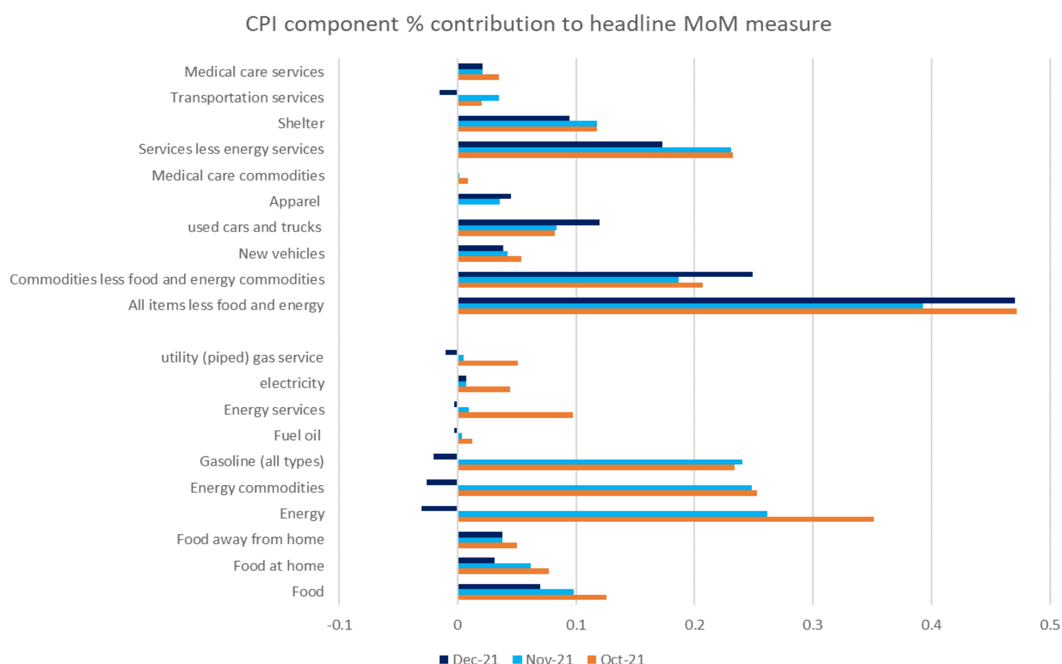
	1-month	3-month	6-month	12-month
EURUSD	1.13	1.12	1.13	1.14
USDJPY	115	116	115	115
DXY	96.09	96.52	95.62	94.97

Federal Reserve set to hike rates in March, but inflation developments and wage growth prove key to how hawkish the Fed will be

As evident in recent FOMC communications, the Federal Reserve will have to become more hawkish with their rate statement in January's meeting following the progress made in the labour market in December and the rise in inflation to a near 40-year high. While we pinpointed areas of weaknesses within the data, such as the likely disinflationary forces that will come into play in January's CPI release and the level of available employment on the sidelines due to a slower recovery in the prime-age participation rate, we don't see these vulnerabilities as significant enough to alter the Fed's near-term rate profile. That is, we now expect the Fed to raise rates by 25bps in March and a further 50bps over the course of the following two quarters before the discussion of quantitative tightening and further rate hikes comes into play when positive base effects and supply chain pressures begin to reverse. In FX markets, we expect this to provide a floor under the dollar, which has been under pressure over past weeks as the market starts to settle on a more balanced outlook for Fed normalisation.

Disinflationary forces start to appear within the CPI and core baskets while the sources of inflationary pressures narrow





"Further CPI and nonfarm payroll reports are required to derive a firmer outlook for Fed policy and to **trigger the next trend for the dollar**."

However, we believe that given inflation is likely to take some time to come down towards levels more palatable for the Fed and market, and the forces in play in the labour market are likely to keep the unemployment rate on track towards the Fed's forecast of 3.4% in Q4 2022 as the participation rate struggles to recover, incoming data should be supportive of initial normalisation.

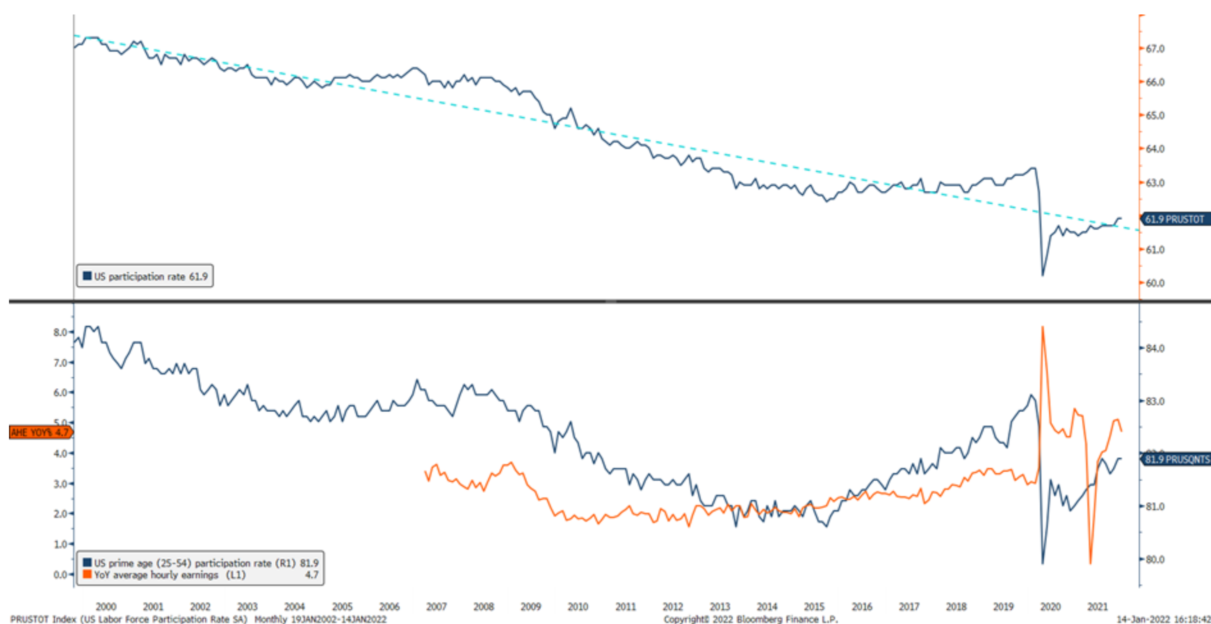
USD Outlook

January 2022

MONEX

Thereon in, the sensitivity of the participation rate to the rise in wages will likely determine the Fed's normalisation path as the Phillips curve comes back to life and threatens formulating the wage-price spiral. If this is the case, focus for FX markets will quickly shift to intermediate and back-end yields as markets will likely start to factor in the Fed's full normalisation cycle and the possibility of rates rising to the Fed's neutral estimate of 2.5%. Should this be the case, risks are tilted to the upside for our DXY calls despite our expectations of a procyclical rally in the currencies like the euro over that time period.

Yes, Bullard is correct in highlighting the structural decline in the participation rate, but prime-age participation is yet to recover close to pre-pandemic levels (1% below) despite rising wage growth



Disclaimer

This information has been prepared by Monex Europe Limited, an execution-only service provider. The material is for general information purposes only, and does not take into account your personal circumstances or objectives. Nothing in this material is, or should be considered to be, financial, investment or other advice on which reliance should be placed. No representation or warranty is given as to the accuracy or completeness of this information. No opinion given in the material constitutes a recommendation by Monex Europe Limited or the author that any particular transaction or investment strategy is suitable for any specific person. The material has not been prepared in accordance with legal requirements designed to promote the independence of investment research, it is not subject to any prohibition on dealing ahead of the dissemination of investment research and as such is considered to be a marketing communication.