Mizuho Brief: FX

Economics & Strategy | Asia ex-Japan

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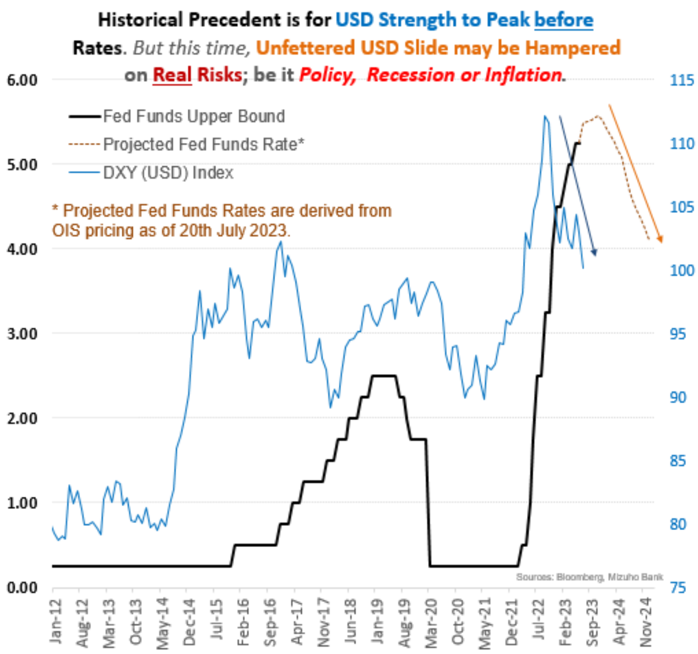
USD: Keeping It Real?

- **USD bears** betting on "peak Fed" risk being **wrong-footed** by *over-estimated "divergence"* and *overdone soft-landing assumptions;* with attendant "risk on" that tends to weaken USD.
- Crucially, **faster US dis-inflation** sharpens **real yield spread advantages** for the USD.
- This **inverts received wisdom** on the higher inflation-currency strength positive correlation for EUR and Majors (DM) FX.
- Apart from **kicking the tyres of rate hike assumptions** associated with higher inflation, this entails a **fundamental shift in viewing DM FX mechanics via real** *rather than nominal* **rate differentials**.
- Arguably, this **"real" shift is compelling** in a world where risks of high and volatile inflation now involve DM; not just an "EM problem".
- And *insofar that EUR tends to have an outsized impact on* determining the wider *USD trend*, **"real" USD advantages compromise scope for fettered EM FX gains** on **"peak Fed"**.

"Peak Fed" Bearish USD Bets

The **instinct to sell USD down on "peak Fed" bets** is *understandable but misguided.*

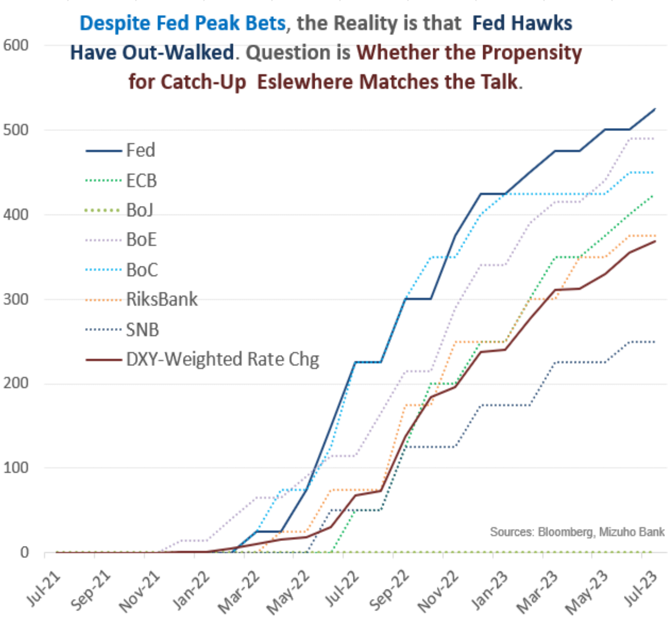


Despite ostensibly compelling empirical evidence of *bearish USD on peak Fed cues*, **unpacking critical drivers** involved not only **de-mystify**, but crucially, **dissociate a bearish USD from "peak Fed"**; by identifying appropriate triggers and conditions.

Accordingly, there are three **very *real* pitfalls of presuming one-way USD decline** *premised on bets that Fed hawks are essentially close to exhaustion.*

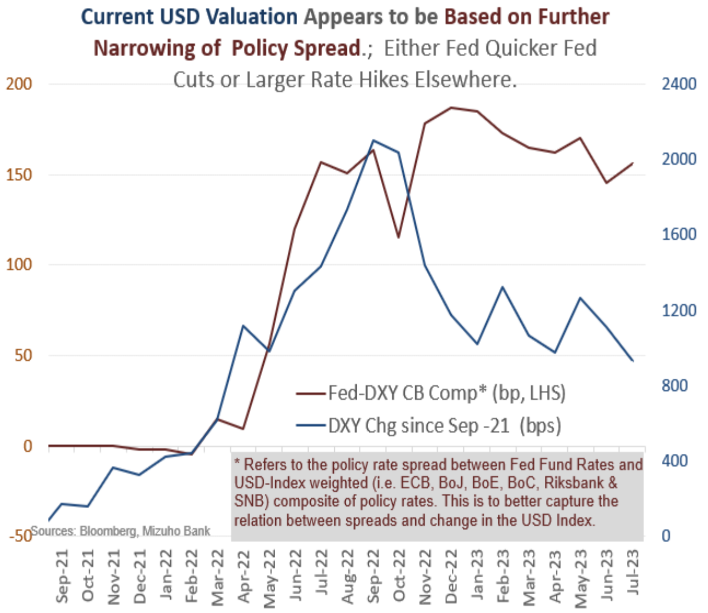
The Divergence Delusion

For a start, **"peak Fed" bets** are really *short-hand for* assumptions of ***relative***, ***dovish*** **Fed divergence**; *resulting in an erosion of US rate/yield advantage* that in turn elicits *attendant USD decline.*

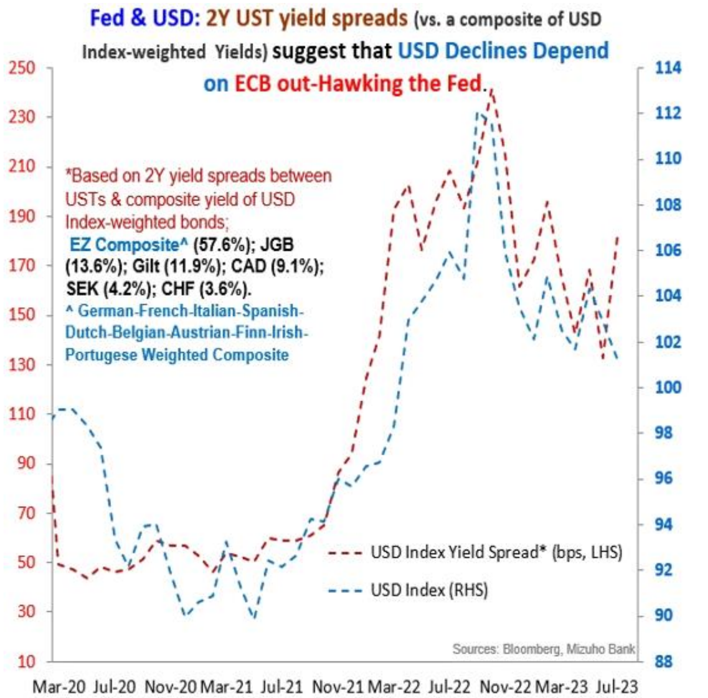


Such divergence requires either; i) **aggressive Fed rate cuts** in quick succession to from "peak" policy rate ***or;*** ii) that **other Major Central Banks persist with significant tightening after the Fed is done**. Trouble is, **neither is compelling**.

Fact is, the Fed's concerns about a "sticky inner core" diminishes scope for deep cuts near-term. And *global hard-landing risks* coinciding with sticky inflation *challenge the notion that other central banks will dangerously flirt with policy-induced recession;* with steep hikes, in sharp contrast to a Fed pivot.

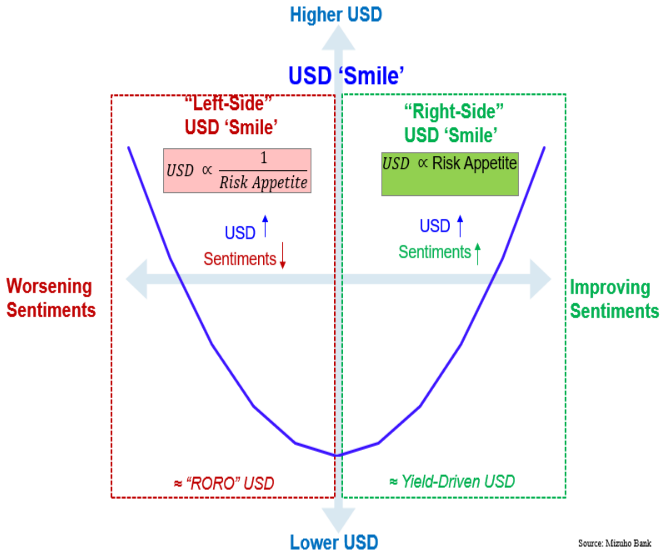


Hence, the **Greenback's pivot down insofar that it relies on the Fed being relatively "out-hawked"**, is likely to disappoint. And reckoning with the **"divergence delusion"**, *must arguably diminish scope for aggressive USD sell-off* (as rate differentials continue to support USD contrary to the "peak" bets). Especially as aggressive pricing for Fed hawks to be overtaken has transmitted to yields as well.



(Overdone) Soft-Landing Cheer?

But even in the absence of dramatic shifts in rates **die-hard USD bears have another "angle of attack"**; which *invokes inherent short USD reflex from relief or "risk on"* via left half of 'USD Smile' mechanics.

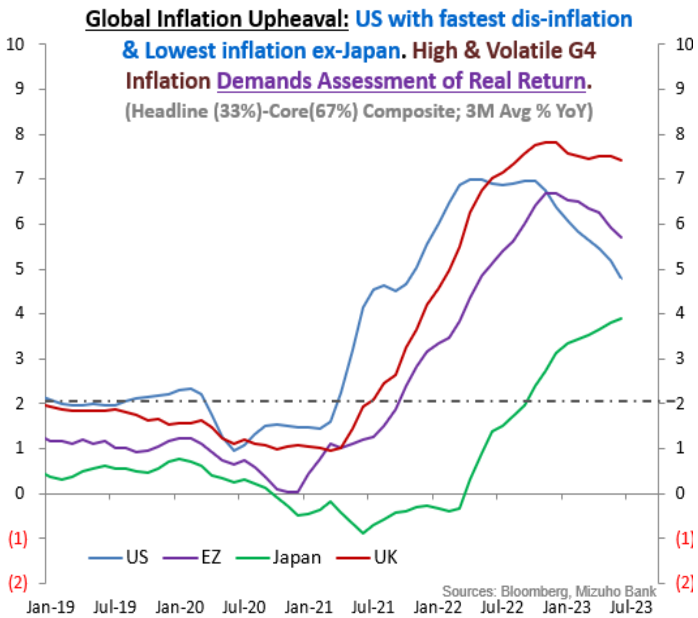


Specifically, *assumptions of "soft-landing"*, **premised on the Fed nearing the end of hikes** (and perhaps approaching rate cuts), is expected to trigger USD declines from relief (or perhaps even optimism).

Inflated Bearish USD Bets

What's more, even on a trend basis, the **US has the fastest pace of dis-inflation**. And *as a corollary*, the *highest rate of pick-up in implied real returns.*

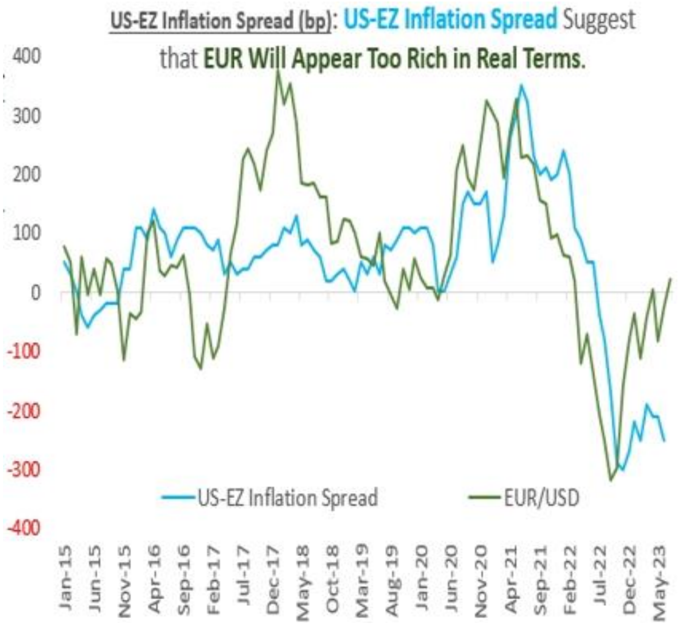
The logic then flows **USD will be getting more**, *not less*, **attractive** from (dis-)inflation dynamics across the developed economies. Especially **as EZ and UK inflation remain far more elevated** while *Japan's inflation has yet to peak.*



Simply put, *USD bears are inflated by virtue of inflation (differentials) not being accounted for;* as **nominal spreads grossly understate or mask the real deterioration in short USD bets**.

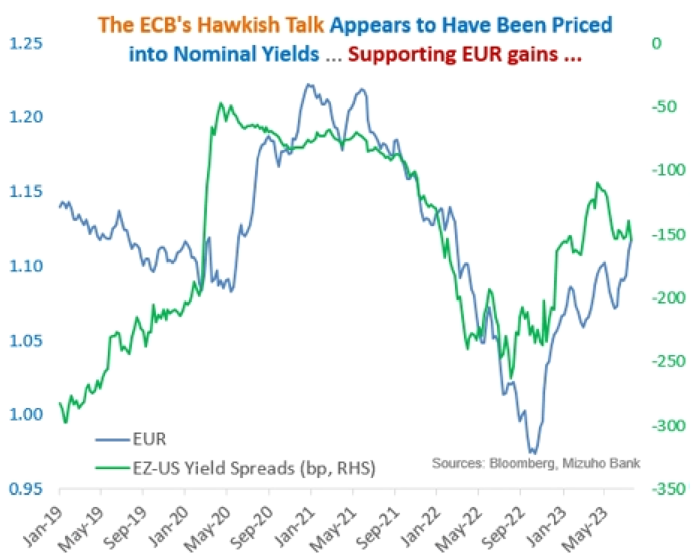
It is worth mentioning that **received wisdom on the irrelevance of real spreads for DM** (and that real spreads only matter for EM) **is fallacious**. Point being, DM used to be assessed on nominal spreads only because low and stable (2%) inflation across DMs rendered inflation differentials irrelevant. But **with DM exhibiting EM-type high and variable inflation**, it stands to reason that **assessment based on inflation-adjusted, real spreads is warranted**.

The Real (Dollar) Deal

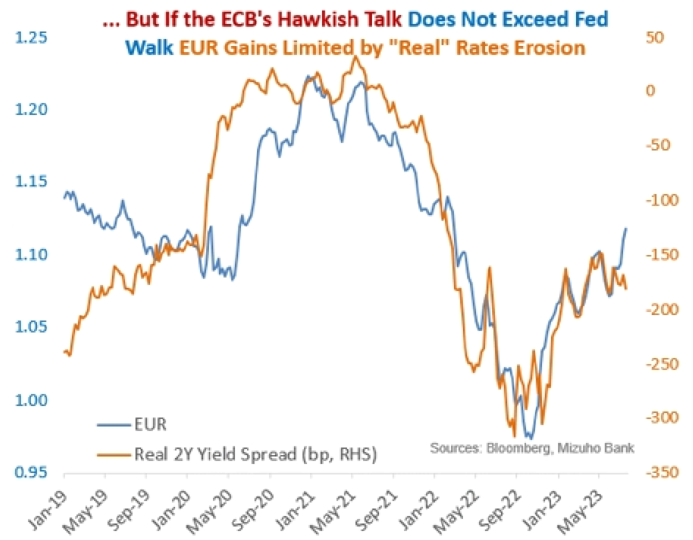


The upshot is that **a shift in thinking to explicitly account for volatile inflation differentials** could **suggest that USD in oversold**. Case in point being **EUR that appears overvalued once inflation spreads** are taken into consideration.

What's more, the **difference in valuation cues between nominal and real yield spreads is stark**.



Nominal yield spreads suggest EUR is only realizing the lift implied by spreads.



Whereas **real yield spreads suggest EUR is overshooting fair value**. And the thing is that *not only is nominal yield behind the curve in expressing the real support* (pun intended) *for EUR*, but it *could also overstate the ECB's hawkish* intent baked into yields.

Dollar Advantage Real-ly Underestimated

And between the two, this reinforces **our view that the USD's decline is exaggerated**. For one, **USD bears are too infatuated with "Peak Fed"** to *realistically assess* the likelihood that *neither ECB nor BoE will materially out-hawk the Fed* given even more precarious recession risks. Second, *adverse risks have not receded durably enough to bank on sustained "risk on" USD pullback*. Finally, *more emphatic US dis-inflation*, spell risks of **EUR and GBP erosion** (with UK's inflation even more acute).

With EUR (~58%) and GBP (l~12%) accounting for such a large weight of the USD index (~58%), the ***evidence is stacking up overwhelmingly in favour of broad-based USD under-valuation in real terms***.

EM Asia FX

This **scope for broad-based USD upside/rebound on real advantages** is a **key reason to not be seduced by** "Peak Fed" arguments as a basis for **unfettered, one-way short USD bets against AXJ**. *More so as CNH downside risks further undermine AXJ traction* in coming months. In short, recognize USD advantages, expect volatility and stay adequately cautious.

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