DXY – Multiple Factors Needed To Convince The Fed For Rate Cuts

9 May 2024

Forecast (Apr 2024)	Spot	0-3m	6 – 12m	Long-Term
DXY	105.75	104.91	108.70	93.48

- Fed's May FOMC statement contains no hawkish pivot or any explicit reference to increasing rates with only one new line added – "in recent months, there has been a lack of further progress toward the Committee's 2% inflation objective". Even then, the statement describes risks are "moving" into better balance. In his subsequent Q & A comments, Fed Chairman Powell argues that it would not be appropriate to dial back the Fed's restrictive policy stance until there is greater confidence in US inflation moving down sustainably to 2%. However, Chair Powell is confident in his own forecast of inflation slowing even if it may take longer than expected for the FOMC to gain sufficient "greater confidence" to begin cutting rates. His comments overall, highlight the basic asymmetry of the Fed's reaction function - that either softer inflation or weaker US labor market data will have the Fed cutting policy rates. Furthermore, he remains adamant that policy rates are sufficiently restrictive and consequently there is little reason to contemplate rate hikes.

- With no "hawkish pivot," Chairman Powell's remarks significantly reduce the odds of the Fed having to run the US economy into the ground towards a harder landing by leaving rates at their current higher level for much longer to achieve its inflation objective. Prior to the May FOMC meeting, such an outcome was gaining widespread publicity among market participants. This drove US bond yields higher and supported a stronger DXY as markets repriced back to "US exceptionalism", noting the resilience of the US economy and that the Fed would need to maintain restrictive monetary conditions for much longer than earlier expected. Sticky inflation would have prevented the Fed from cutting rates to stimulate an economy already feeling the strain from higher rates which may have then led to the hard landing scenario for the US and the global economy, resulting in safe haven inflows into USD due to the rise in global risk aversion as a result.

- But that scenario now looks increasingly unlikely as the May FOMC signals the Fed's willingness to engage in multiple rate cuts to engineer a softer landing for the US economy once the Fed gains greater confidence that US inflation is moving down sustainably to 2% and/ or the US labor market weakens sharply. With geopolitical tensions also subsiding, the threat of a sizeable strengthening in DXY as a safe haven has receded considerably and more likely, DXY now looks to be range-bound until the Fed signals its readiness to commence rate cuts. A US softer landing will likely provide a more supportive backdrop for risk assets and currencies, particularly those linked to commodities such as AUD. As the Fed cuts rates, interest rate differentials are also likely to move against USD (note the RBA is expected to be the last among major central banks to cut rates in 2025). Together with a more positive investor risk appetite from lower Fed rates that also likely lifts commodity prices, this combination could support a stronger AUDUSD over the medium term notwithstanding China's tepid recovery.

DXY Looks To Be Peaking

Source: Bloomberg, May 2, 2024

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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