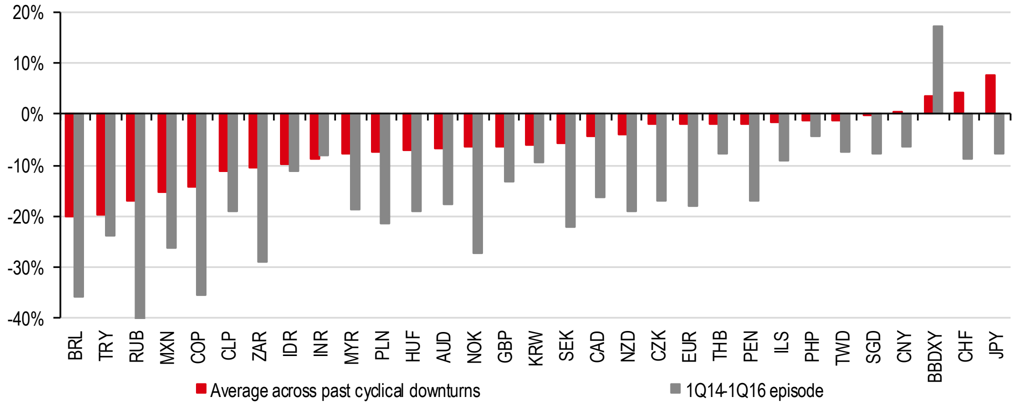
Overview: The waves of doubt

- The Delta wave has affected some key US data points, potentially delaying tapering
- Some may also wonder if tapering even matters for FX
- We believe global growth momentum and monetary policy divergence remain key for the USD's outlook

In the previous edition of the Outlook, we outlined our arguments as to why the USD is likely to gradually strengthen over the coming quarters (see '*As the world turns…', Currency Outlook, 11 August 2021*). First, **the peaking of global growth, sequentially, would mark the end of the USD's broad cyclical decline**. Second, the Fed's path towards policy normalisation should support the USD gradually, especially when tapering actually starts. Over the past year, we have frequently discussed the former in our USD framework. Tracking the performance of currencies and global growth indicators highlights the counter-cyclical nature of the USD (Chart 1). It tends to underperform when global growth is accelerating but recover when the opposite conditions emerge.

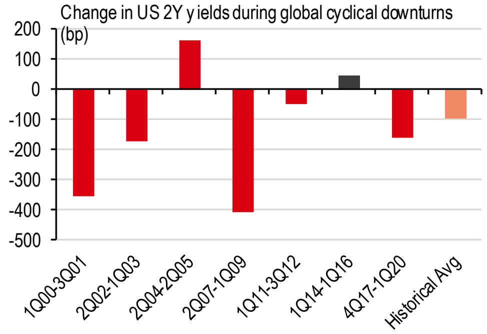
We have also been quick to point out that **our forecasts for USD appreciation are modest**, as global growth may be losing speed but is not seen decelerating quickly. If we believed the latter could occur, then we would factor in a much steeper USD climb. A slow and steady USD rise as global growth loses momentum will be a headwind for the more cyclically sensitive currencies, in particular for EM and commodity FX. Nonetheless, we need to consider an alternate scenario that is relevant and could cause the USD to strengthen faster than expected. Indeed, the period between 2014 and early 2016 saw the combination of the global economy cooling and higher short-term US interest rates (i.e. 2-year yield). This was normally not evident in other periods when the former was slowing (Chart 2). **These developments taken together coincided with larger depreciation pressures for a number of currencies**, including the anti-cyclical currencies like the JPY and CHF.

1. The broad USD tends to strengthen when the global economy is cooling and even more so when US short-term yields are rising



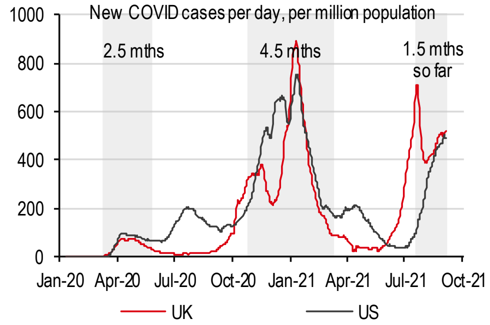
Source: Bloomberg, HSBC

2. Will the upcoming cyclical soft patch resemble the 1Q14-1Q16 period?



Source: Bloomberg, HSBC

3. COVID-19 in the US has been challenging lately



Source: Our World in Data, HSBC

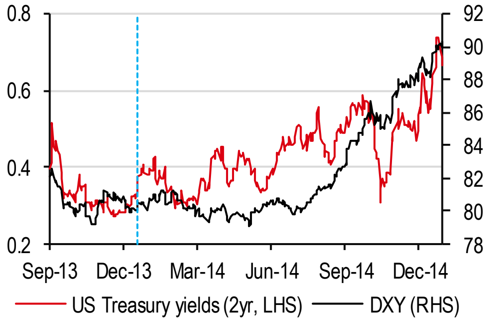
Fed's Delta doubt

Some may quickly argue that such concerns about higher front-end US Treasury yields are not warranted. After all, **the US economy is losing some speed and as a result there is a possibility that the Fed could soften its message.** It has been well discussed how the Delta variant in the US has been challenging and that has been cited as a near-term downside risk by the Fed (Chart 3). A potential delay in the slowing of the Fed's balance sheet would test the USD, although we believe it would be temporary. Once the spread of the Delta variant shows a sign of peaking, as it has done elsewhere, then the Fed would presumably resume its path towards gradual normalisation. In other words, the Fed may have some doubts about the US economy in the near-term, but it is unlikely to abandon its long-term view and plan for monetary policy normalisation.

Descartes and the method of doubt

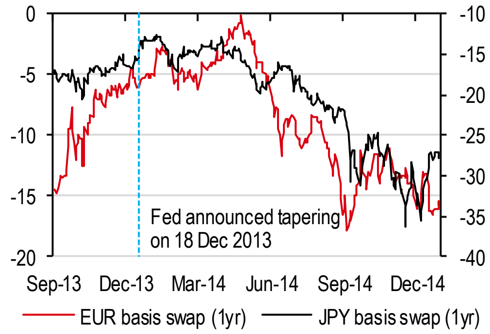
Leaving aside whether the Fed holds back from announcing plans to taper at the September meeting, there is still plenty of doubt that this will even matter for exchange rates. There are many valid points to this thinking given how much the Fed has mentioned its intentions over the past year. Plus, the experience in December 2013 is often cited when the Fed first detailed the actual reduction of its asset purchases. The tapering was very measured, starting with a reduction of USD5bn for US Treasuries and MBS for USD5bn (to USD40bn and USD35bn, respectively). The USD hardly moved and liquidity was flush in the months after the Fed's tapering begun (Charts 4 and 5). **This reference for the USD to late 2013 and early 2014 gives support to the doubters**. But we have some apprehension with this thinking for FX. In H2 2014, the USD staged a pronounced recovery that gives important food for thought.

4. How did the USD perform after tapering was announced in December 2013?



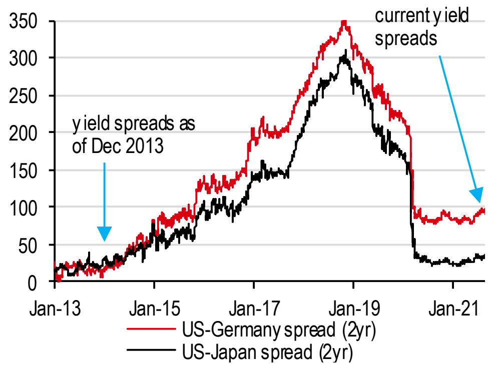
Source: Bloomberg, HSBC

5. USD liquidity was flush when the Fed announced the tapering in December 2013



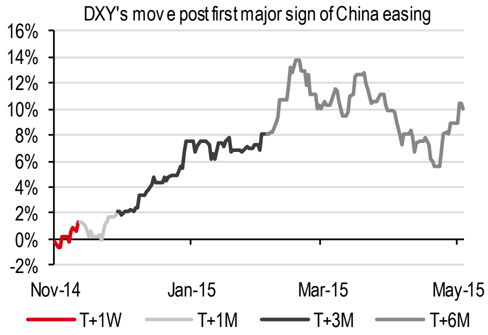
Source: Bloomberg, HSBC

6. The present yield spreads are in favour of the USD compared to December 2013



Source: Bloomberg, HSBC

7. The start of the PBoC's easing cycle in 2014 coincided with DXY strength



Source: Bloomberg, HSBC

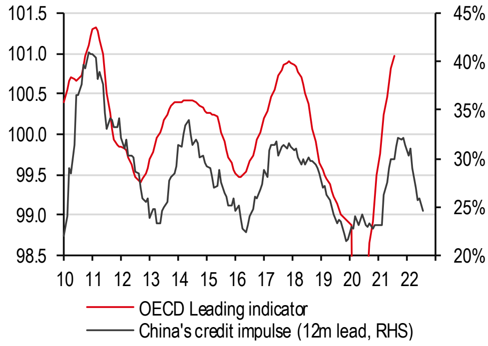
Divergent – no doubt

In December 2013, the announcement of tapering did not have much impact on the USD but this misses some points. First, the monetary policies of the Fed and other major central banks were less divergent than they are today. For example, the effective Fed policy rate was 12.5bps compared to 0bps for the ECB and 10bps for the BoJ. Currently, the policy rate gap is +72.5bps and +20bps for the Fed over the ECB and BoJ, respectively. This was also the same message with short-term rate differentials. The US-Germany 2-year spread was 15bps and the US-Japan 2-year spread stood at 25bps. At the time of writing, this is relatively wider in favour of the USD, especially against the EUR (Chart 6). **Our point is that there was less policy divergence in late 2013, which explains the lack of response by the USD to the taper announcement.**

Second, things began to change in mid-2014 when policy divergence was increasingly stark. There were rising expectations that the ECB could introduce QE and the BoJ accelerated its asset purchases in October that year. Meanwhile, the market's view of the Fed was shifting onto a more hawkish path, as 2-year yields rose and supported the USD broadly (Chart 4, again). These may be rather trivial but, in a world of low yield, we believe these small differences mattered.

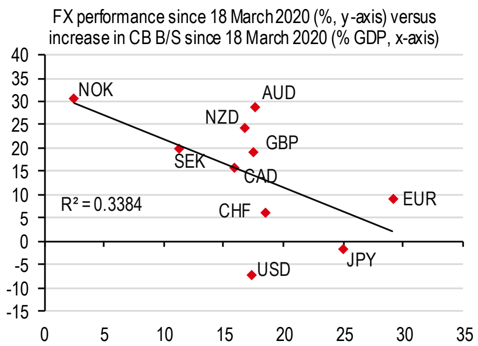
Meanwhile, there was another sign of divergence that eventually took hold, which led China's economy to slow. The PBoC started an easing cycle in H2 2014 that only added to the USD's resilience, as the RMB weakened (Chart 7). In this context, there is a sense of history rhyming yet again with the moderation of China's economy this year. We take note of this, especially since there is a relationship between China's credit impulse leading previous periods of global growth and deceleration (Chart 8).

8. China's credit impulse has slowed and led previous global growth cycles



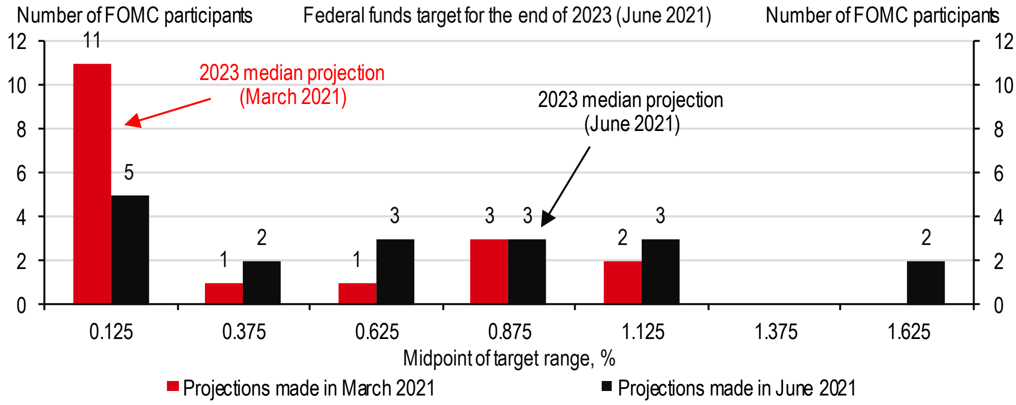
Source: Bloomberg, HSBC

9. FX performance and balance sheet expansion; the USD is an outlier



Source: Bloomberg, HSBC

10. The Fed's dots will matter for the forward guidance



Source: Federal Reserve, HSBC

There have been a lot of comparisons to the start of the Fed's tapering and doubts that it will matter for FX. We are less convinced if it emphasises the longer-term force of policy divergence. In our view, this means relative central bank balance sheets are important, which we have regularly argued. **The strong relationship between the size of unconventional policies and currency performance since March 2020** (Chart 9). Yet, the USD is an outlier in that it is weaker than the wider relationship suggests and could change once the tapering starts. What may matter more is if the Fed's tapering brings the idea of rate hike expectations forward. This was not the case in 2013 and also explains the USD's muted reaction. This time could be different. **We understand the argument that the start of tapering may not impact other markets, but we are doubtful it will not impact the USD over time**.

Dot doubt

Let's also not forget that the Fed's forward guidance is an essential determinant of the USD. An important lesson was delivered at the June meeting when the Fed's message was hawkish given the shift in 'dots' to signal the potential for larger and faster rate increases. Some may doubt that the Fed will do so again given the impact of Delta and the series of weaker than expected data recently. However, **the Fed will need to outline its thinking via the dots for 2024 and whether it implies a continuation of rate hikes. Such an implicit shift in the Fed's forward guidance could again be interpreted as a hawkish** signal that could cause the USD to strengthen. Similarly, the risk of more dots calling for hikes in 2022 is another scenario that could impact the Fed's guidance and one that would be positive for the USD. On the other hand, if the Fed plays it safe with the dots, we doubt the USD would resume a meaningful and sustained decline. A slower path for the Fed could lead other central banks to follow suit.

Conclusion – no doubt about it

It is only natural to have doubts. The USD's fortunes have been less straightforward compared to last year. We believe the dollar is gradually transitioning onto a stronger path as two forces come together, namely the moderation in global growth and the Fed taking a gradual but divergent path towards eventual rate hikes. We acknowledge that the Fed's tapering may not lead to an immediate reaction and impact on the USD. However, it should still set the course for bigger policy divergence to play out for exchange rates. We have little doubt about this point.