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Higher for longer US rates would help dollar regain lost ground

Tuesday, November 28, 2023 12:11 PM ET

By Brian Scheid
Market Intelligence

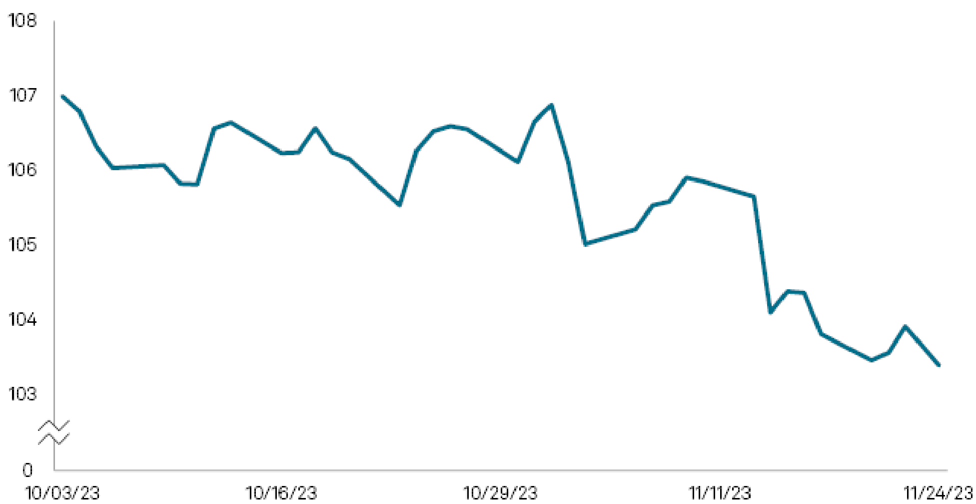
The US dollar may be poised for a turnaround from its recent downturn against other major currencies as recent US economic strength pressures the Federal Reserve to keep interest rates elevated.

Since it peaking in early October, the US dollar index, which measures the greenback against a basket of six G10 currencies, has fallen about 3.4% as Fed officials indicated that they are done raising interest rates even as inflation growth remains above the central bank's 2% target and unemployment remains below 4%, contributing to wage growth.

Yet the strength of the US economy — with joblessness relatively low and real gross domestic product rising at an annual rate of 4.9% in the third quarter — could keep rates at current levels for much longer than most traders are betting, causing a policy divergence with other central banks around the globe and sparking another US dollar rally.

"We have to respect this move in rates and the dollar for now, but I think it's wrong and will be repriced, hopefully in early 2024," said Win Thin, global head of currency strategy with Brown Brothers Harriman & Co.

US dollar index has fallen 3.4% from 2023 high (index value)



Data accessed Nov. 27, 2023.
Source: S&P Global Market Intelligence.
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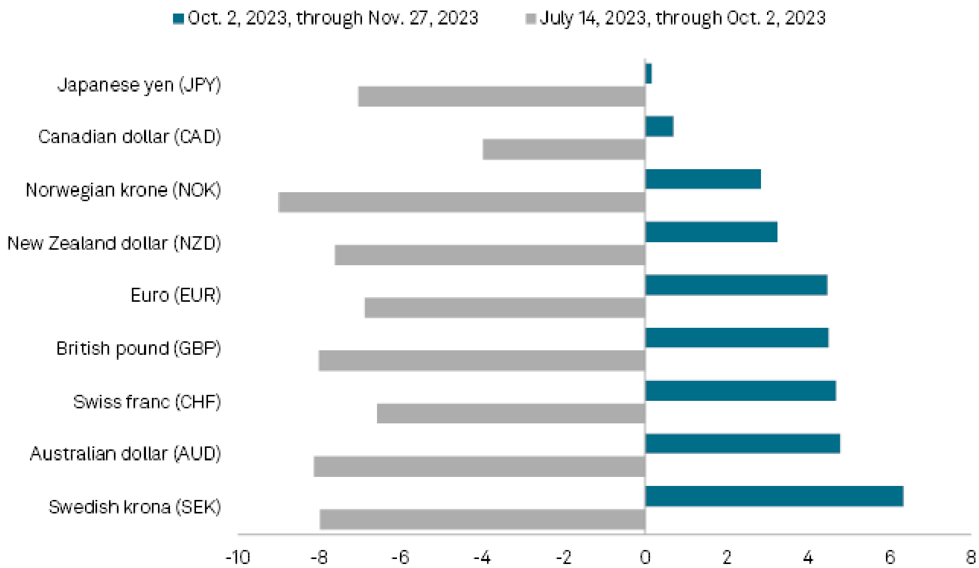
Cuts predicted

Economists with the banking and financial services company ING are forecasting the Fed to cut its benchmark fed funds rate by 150 basis points throughout 2024, as the drawdown in household savings and the effects of high interest rates have boosted the chances of a recession next year.

"Should the US economy prove more resilient than what markets are currently pricing, then the dollar will find renewed strength in 2024," said Francesco Pesole, a foreign exchange strategist with ING.

The dollar tends to rise with interest rates, and tighter monetary conditions, as investors move to government bonds and other dollar-denominated securities. A strong US dollar helps lower the cost of foreign goods while increasing the price of US exports and chilling global demand. A rally in the US dollar in 2022 added pressure to inflation worldwide and increased the costs of foreign debt service.

After losing ground, G10 currencies have rallied against US dollar over past 2 months (%)



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With the most restrictive monetary policy now viewed as over, the dollar has fallen against its G10 peers. The Swedish krona, for example, has jumped 6.33% since Oct. 2, after losing 7.99% to the dollar from July 14, 2023, through Oct. 2, 2023.

Misplaced bets primed to spark turnaround

These gains, however, could be reversed if the Fed decides the domestic economy can withstand elevated rates for longer as foreign central banks, faced with potential steeper recessionary risks, decide to cut rates earlier.

Futures market investors are assuming most major developed central banks will begin to ease policy around the middle of 2024, according to an analysis by Corpay Cross-Border Solutions.

Markets are assuming the Fed will cut its benchmark rate by roughly 70 basis points by the end of 2024 roughly in line with expectations that the Bank of England will cut by 60 bps, the European Central Bank will cut by about 70 bps, and the Bank of Canada will cut by 90 bps, according to the analysis.

"Hence, if the Fed doesn't lower rates as much as anticipated, and/or by less than the other major central banks, we would expect to see the [US dollar] regain some lost ground as bond yield differentials shift in favor of the US," said Peter Dragicevich, currency strategist with Corpay. "This is a risk scenario for 2024, but not our base case."

The dollar index still remains about 5% higher than it was when the Fed first began hiking rates in 2022 and Thin with Brown Brothers Harriman said he expects some seasonal factors to impact the index this month.

The index has weakened every December since 2017 and has fallen during the month in 14 of the past 20 years, Thin said.

"This fits in with the market narrative that no one wants to stick their necks out as year-end approaches and will instead stay with the weak dollar trades," Thin said.

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