Daiwa's View

FICC Research Dept

Soft landing and dollar depreciation

- If US growth slows and expectations of monetary easing gain traction, the dollar will inevitably weaken
- Cross yen rates remain firm and yen weakening pressures persistent, albeit with small declines in the USD/JPY
- If the US moves from a soft landing to a hard landing scenario, crisis will bring dollar strengthening and strengthen the yen the most of all currencies

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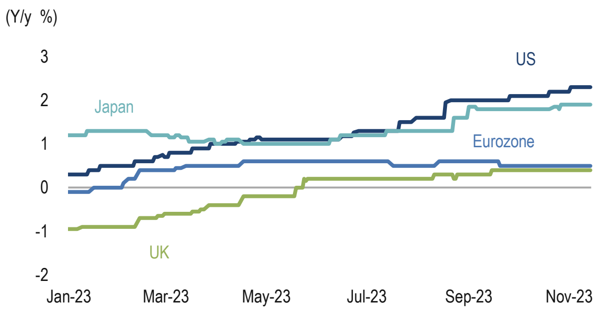
The most unexpected development this year was strong real GDP growth in the US in 2023. The consensus US growth forecast among private sector economists at the start of 2023 was only +0.3%, but that steadily rose over time and is now up to +2.3% (Chart 1). Outlooks were raised in all the other major economies up until early summer, but since then upward revisions continued in the US but flattened out in the euro zone and the UK, highlighting the strength of the US economy.

Dramatic monetary tightening has not had much impact in the US but has already weakened the euro zone and UK economies. Slower credit growth in the euro zone and UK are an indication that demand is being restricted by central bank tightening (Chart 2). In Japan, where monetary policy has remained accommodative, growth forecasts started out the year already high and have been raised to the same extent as in the US since the summer.

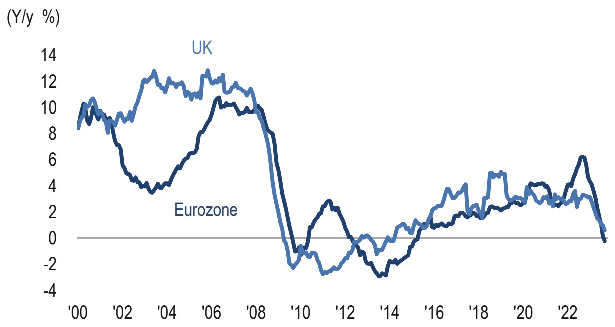
Reflecting these differences in economic trends, the dollar started strengthening in the summer. The dollar index (DXY) had fallen below 100 in mid-July but climbed to above 107 by early October. During that time, the EUR/USD fell from a high 1.12 to a mid 1.04 and the GBP/USD dropped from a mid 1.31 to a low 1.20. The USD/JPY likewise rose from a low 137 to over 150, but unlike many of the other currencies which then rebounded, the yen kept weakening against the dollar.

Chart 1: Consensus Estimates for Real GDP Growth Rate in 2023



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Bank Lending in Eurozone and UK



Source: ECB, BOE; compiled by Daiwa Securities.

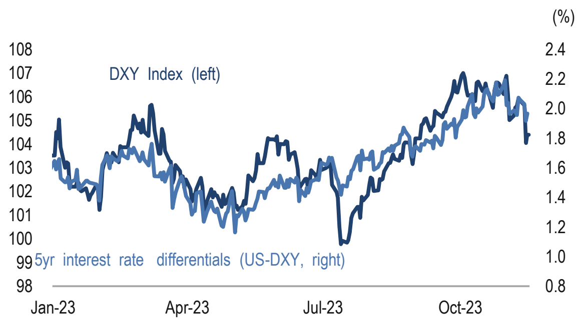
Starting in November, however, concerns started to mount over a US economic slowdown. The economic data announced over the past few weeks included lower-than-expected jobs data and a softening of the ISM indices for both manufacturing and services, and this has buttressed the view that there will be a significant slowdown of the US economy. The CPI numbers announced this week clearly showed that the disinflation process is gaining traction. In response to the US economic data, expectations of an additional Fed rate hike in 2023 have all but disappeared and the 10yr Treasury yield, which had risen above 5% in late October, has backed down to around 4.5%. The dollar has been moving in step with interest rate differentials, and the recent decline in US interest rates pushed the DXY down below 105 (Chart 3).

As noted above, the USD/JPY has remained in a rising trend despite the recent dollar weakening trend, and we think the carry trade is one reason why. Global stock markets, liking the declining trend in interest rates since the start of November, have been rising. Expectations of a soft landing for the US economy are strongly rooted in the market, and the economic data, which point to mildly slower growth and moderating inflation, have fueled a decline in interest rates and rise in share prices. Evidence of this is that many currencies have risen against the dollar in response to declining US interest rates and cross yen rates have been rising across the board (Chart 4). Downward pressure on the dollar from declining US rates is also affecting the USD/JPY, but because some of that is being offset by yen weakening pressures led by cross-yen pairs, the USD/JPY has not been declining.

If US growth slows and expectations of monetary easing gain traction, the dollar will inevitably weaken, but the path it follows will not be smooth. The market is increasingly expecting the Fed to turn dovish, and if this leads to a further rise in share prices, tightening of credit spreads, and weakening of the dollar, US financial conditions will become more accommodative. That would boost the economy, create inflationary pressures, and ultimately force the Fed to continue tightening.

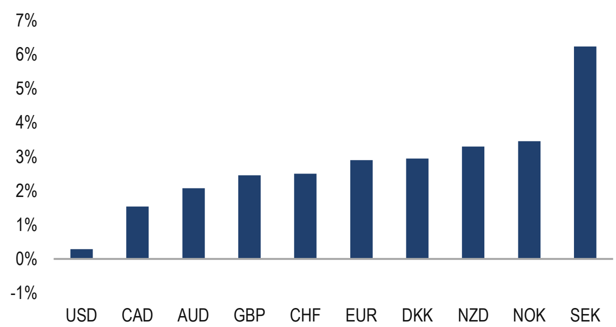
If the Fed does not cut rates as disinflation progresses, Fed policy will automatically become tighter. Speculation of a Fed pivot has risen then disappeared numerous times so far, but can the Fed somehow achieve a soft landing while that continues? We have our doubts. The dollar will probably continue weakening while the market is still expecting a soft landing. At the same time, it is likely that cross yen rates will remain firm and yen weakening pressures persist, albeit with small declines in the USD/JPY. If the US moves from a soft landing to a hard landing scenario, however, it is likely that crisis will start strengthening the dollar and strengthen the yen the most of any currency.

Chart 3: Dollar Index (DXY), 5yr Interest Rate Differentials



Source: ICE. Bloomberg; compiled by Daiwa Securities.
Note: Interest rate differentials are weighted averages based on the respective currency's weighting in the DXY index

Chart 4: Rate of Change in G10 Currencies vs. JPY (from Nov)



Source: Bloomberg; compiled by Daiwa Securities.

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