



CIO recommends investors use periods of near-term dollar strength to reduce exposure to the currency, or to engage in volatility-selling strategies to generate portfolio income. (UBS)

US dollar rally is unlikely to be sustained

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The US dollar has climbed close to its highest level of the year. The DXY index, which tracks the US currency against six major peers, is up around 1.2% so far in June, leaving it just 0.3% below the 2024 high set in April. This strength reflects a combination of factors, including the fact that the Federal Reserve has been keeping rates high for longer while other major central banks—including the European Central Bank, Swiss National Bank, and Bank of Canada—have already started cutting.

Since investors often view the US currency as a safe haven, it has also likely been benefiting from political uncertainty surrounding the French legislative elections—with the first round of voting taking place this Sunday.

Notably, the US dollar has gained around 14% against the yen since the start of the year, breaking above the 160 level this week to push the Japanese currency to its weakest level since 1986. The euro, which is the largest constituent in the DXY index, has also fallen more than 3% against the dollar in 2024.

Further upward pressure on the US dollar remains possible in the near term. If former US President Donald Trump is perceived as more likely to win the election after the first televised debate with President Joe Biden later today, this could lift the US currency—given the potential for looser fiscal policy if the Republican Party wins both the White House and control of Congress. The prospect of fiscal easing could push yields higher at the back end of the curve. The outcome of the French election on Sunday could weaken the euro in the event of a strong result for either right- or left-leaning parties.

Despite this, we believe recent US dollar strength should fade in the coming months, as a slowdown in US growth allows the Fed to start cutting rates in September, which is our base case. The greenback, which we view as richly valued, should

also face downward pressure as markets start to price a deeper Fed rate-cutting cycle. Finally, fears about the size of the US fiscal deficit may prove to be another headwind over the longer term.

Against this backdrop, we see several implications for other major G10 currencies:

Near-term risks to the euro should give way to favorable macro outlook. The outcome of the French elections is uncertain, with the nation's two-round voting process adding to the difficulty of predicting the victor. However, we see limited room for additional euro weakness as a "Frexit" narrative, in which France seems set on a course to leave the European Union, looks unlikely to develop at this stage. Moreover, a nascent recovery in business sentiment in the region suggests an ongoing improvement in economic activity. Coupled with a rebound in global trade, we see a favorable outlook for the euro relative to the USD.

While yen weakness is likely to persist until later this year, we don't favor chasing the US dollar rally. We have recently raised our US dollar forecasts versus the yen to reflect the still-wide US-Japan yield differentials and strong portfolio outflows from Japan. Markets remain convinced that intervention by the Japanese government to support the yen will only have a short-lived impact, and that steps taken by the Bank of Japan to normalize monetary policy will remain gradual. However, we expect US-Japan yield differentials to narrow meaningfully by year-end, since US yields have tended to fall more quickly than policy rates once a rate-cutting cycle begins. We would refrain from chasing USDJPY higher or taking yen loan exposure. In our view, the extent of yen weakness and elevated short-yen positioning make such exposure vulnerable to the risk of a sharp reversal.

The Swiss franc should appreciate further. The surprise second rate cut by the Swiss National Bank last week halted the franc's recent rally. But we think the central bank will soon be done with cutting rates. In fact, we expect just 25 basis points more of easing. In our view, the Swiss franc should appreciate from here given narrowing yield differentials between Switzerland and the US as well as Europe in the months ahead. Additionally, the franc is renowned for its safe-haven qualities, offering stability amid political uncertainty in Europe, the US, and elsewhere. We have a most preferred stance on the Swiss franc.

So, we reiterate our view that the US dollar should weaken over the medium term amid US interest rate cuts and fears about the US fiscal deficit. We recommend investors use periods of near-term dollar strength to reduce exposure to the currency, or to engage in volatility-selling strategies to generate portfolio income.

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