With more soft US data likely ahead, CIO believes the US dollar remains a sell in case of rallies. (UBS)

CIO continues to advocate selling USD upside for a yield pickup in coming months

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The US dollar came under further pressure after the consumer price index for June showed underlying inflation rising at its slowest pace in three years. The DXY index, which tracks the greenback against six major currencies, fell as much as 0.9% on Thursday in the minutes after the data release, though it rebounded slightly during Asia morning trade on Friday.

With headline CPI registering the first monthly decline (–0.1%) since December 2022, and the core measure—which excludes food and energy—advancing by the smallest in three years (+0.1%), the report added to confidence that a pivot from the Federal Reserve is getting closer. It is also the latest in a series of soft data that have weighed on the US dollar in recent weeks. Since late June, the DXY index has fallen 1.4%.

The door now appears wide open for the Fed to begin cutting interest rates, in our view, with both inflation and the labor market softening. We expect the US central bank to use the FOMC meeting at the end of the month to signal that it is prepared to cut at the September meeting as long as the data continues on its recent trend. This means that the US dollar should continue to trend lower—we expect the DXY index to fall to 103–104 in the coming days.

We continue to advocate selling USD upside for a yield pickup in the coming months, as market expectations of a deeper Fed rate-cutting cycle and fears about the size of the US fiscal deficit are headwinds for the greenback in the near future and over the long term.

Against this backdrop, we see several opportunities in other G10 currencies:

The Swiss franc should benefit as the Swiss National Bank is likely near the end of its easing cycle. We believe the SNB policy rate is now closer to its terminal value after two cuts this year amid a decrease in underlying inflationary pressure, with one final cut likely in September. This means the Swiss franc should appreciate against both the US dollar and the euro over the next 12 months as the Fed and the European Central Bank ramp up monetary policy easing. The narrowing rate differential between the US and Switzerland should allow USDCHF to fall back toward 0.87, from around 0.896 at present, while political uncertainty and fiscal consolidation in Europe should support safe-haven flows to the franc.

The Australian dollar has room to appreciate amid sticky core inflation. Following the stronger-than-expected inflation data for May, we think a robust labor report and higher quarterly CPI for the second quarter will likely lead to a rate hike by the Reserve Bank of Australia in August. This underpins our recommendation to sell the downside price risks of AUDUSD. We also see an opportunity to go long the Australian dollar versus the New Zealand dollar, as the Reserve Bank of New Zealand (RBNZ) made a surprise pivot this week noting deteriorating economic activity and easing inflation. We now expect the RBNZ to cut rates in August, instead of November, and believe the New Zealand dollar may underperform other G10 currencies.

Yen weakness should be limited in the near term with stretched short positioning. The Japanese yen jumped as much as 3% against the US dollar after the US CPI print pushed the Treasury yield lower, and as Japanese officials appeared to have conducted another round of intervention with yen purchases. While we only expect US-Japan yield differentials to narrow more meaningfully by year-end, we advise against chasing USDJPY higher or taking JPY loan exposure. Given that speculative investors' short yen positions are close to a record, we think that USDJPY could see bouts of pullbacks if US data continues to point to a soft landing. For investors with existing short USDJPY trades, we favor using short-term pullbacks to reduce or exit these positions.

Overall, with more soft US data likely ahead, we believe the US dollar remains a sell in case of rallies. Investors can also engage in volatility-selling strategies to generate additional income. Main contributors - US dollar weakens as CPI reinforces hopes for Fed rate cuts

Original report - **US dollar weakens as CPI reinforces hopes for Fed rate cuts, 12 July 2024.**