Further significant dollar weakening would require a sharp narrowing in the growth and interest rate gap between the US and the rest of the world, in CIO's view. (UBS)

US dollar sell-off looks overdone

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The US dollar declined further at the beginning of Thanksgiving week, as markets continue to recalibrate their US interest rate expectations.

Softer-than-expected inflation and activity data contributed to a 1.8% decline last week in the DXY Index, which tracks the US currency against six major peers. This was one of the sharpest USD sell-offs since July. Selling resumed on Monday as markets further raised their expectations that the Federal Reserve would need to loosen policy sooner in 2024. The CME's Fed Watch tool, which uses US interest rate futures to derive market-based probabilities, now indicates a 29.2% chance of a first Fed rate cut as soon as next March—up from just 10.5% one week before.

But as we outline in our *Year Ahead* publication, we think the US dollar is more likely to consolidate and stay rangebound against major currencies in early 2024, rather than fall further for now:

US growth still looks stronger than in many developed economies. Further significant dollar weakening would require a sharp narrowing in the growth and interest rate gap between the US and the rest of the world, in our view. We don't see this happening imminently, so we think the USD market reaction may be overdone. For example, the US headline inflation print of 3.2% year-over-year in October undershot consensus estimates by just one-tenth of a percentage point. Our expectation is for real US GDP growth to average 2.4% this year and 1.1% next, versus just 0.5% and 0.6%, respectively, for the Eurozone.

The Federal Reserve may not be the first to cut rates. Overall, we believe the combination of lower growth and lower inflation should lead many major central banks to cut interest rates in 2024. But Fed Chair Jerome Powell has warned against inflation "head fakes"—the potential that the falling trend could go into reverse. We expect two to three 25 basis-point cuts by the Fed next year, which—depending on the strength of the data—may not start until the summer. This may turn out to be after the Bank of England and European Central Bank, for which we forecast three cuts each starting in May and June, respectively. With a sharp narrowing of yield differentials unlikely over this period, we expect a

rangebound US dollar for the first quarter of 2024 and before the USD resumes its weakening against the euro, British pound, Japanese yen, and Swiss franc.

Geopolitical and oil market uncertainty could limit further moves before year end. The near-5% drop in crude oil prices last Thursday tends to support risk-on currencies like the euro more than the US dollar, especially given the euro area's sensitivity to global growth, trade, and—by extension—the cost of energy. However, the next OPEC+ meeting on 26 November may be more supportive of both oil prices and the USD. We'll be watching for an announcement of an extension or surprise deepening of voluntary Saudi and Russian oil supply cuts through next year as potential catalysts for the greenback.

So, overall we expect the US dollar to stay stable in the first months of 2024, due to robust US economic growth and high US interest rates relative to the rest of the world. For investors whose base currency is the US dollar, we think selling the dollar's upside potential or selling the dollar on rallies may be attractive strategies to generate income or diversify holdings. For investors based in the euro, the British pound, the Swiss franc, or select other currencies, we recommend finding range-trading opportunities against the US dollar.

For more details on these ideas and more, click here for our **Year Ahead 2024: A new world.**

Main contributors - Solita Marcelli, Mark Haefele, Dominic Schnider, Thomas Flury, Matthew Carter, Vincent Heaney, Jennifer Stahmer

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