

FX Viewpoint

Currencies
Global

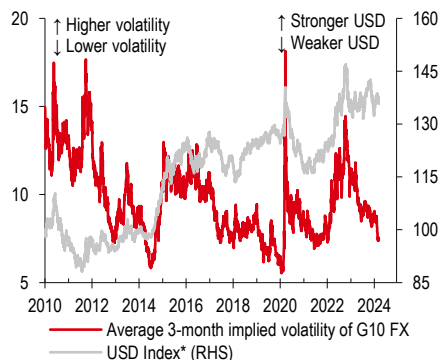
Lower volatility, weaker USD?

- ◆ FX market volatility has fallen sharply recently and, at the same time, the broad USD has softened...
- ◆ ...supported by stronger risk sentiment and a slight uptick in global PMI
- ◆ However, it is questionable whether there is enough strength in global activity to justify more pronounced USD weakness

Higher FX volatility is often associated with a stronger USD – note the spikes in both the red and grey lines in 2014, 2020, and 2022 in Chart 1. However, FX market volatility has dropped sharply recently, so a natural question that arises is whether lower FX volatility means a weaker USD. Chart 1 shows **falling volatility and a weaker USD in 2017 and 2H20-1H21, but not in 2019**. In other words, lower FX volatility does not necessarily imply a weaker USD.

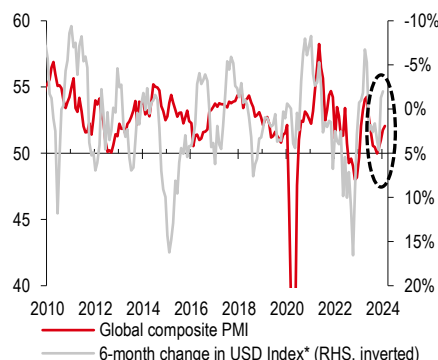
The recent fall in FX volatility has been in part due to a scaling back of rate hike expectations since October 2023 and a loosening of global financial conditions. This has fed into stronger risk sentiment and a slight uptick in the global purchasing managers' index (PMI). Indeed, the composite index rose to an eight-month high in February. **Such global optimism is usually related to USD weakness, but the recent USD decline appears to be overshooting** (Chart 2).

1. FX volatility and USD



Note: *USD Index is derived from an equally weighted G10 FX basket.
Source: Bloomberg, HSBC

2. Global PMI uptick looks priced in by the recent USD weakness



Source: Bloomberg, HSBC

It is also worth noting that the recent uptick in global activity has been smaller and slower than many of those past episodes when the US Dollar Index (DXY) dropped by at least 10%, for example, in 2017, 2H20-1H21, and 1H23. **Global growth momentum has also been less uniform this time round**, with manufacturing PMIs remaining in contractionary territory in most economies, while services surveys have remained resilient in most of the world. **For the USD to trend notably lower, we believe that the global activity data likely needs to show a much clearer upward trend, with stronger economic activity outside the US.**

Another challenge for the current lower-volatility, lower-USD narrative is that **inflation momentum is a bit stickier in the US, compared to most other G10 economies**. If the Federal Reserve is not able to deliver rate cuts relative to current rate pricing, there is likely to be a re-tightening of financial conditions and some modest downside risks for rebounding global growth momentum and risk appetite. But it will also present more direct upside for the USD via the rates channel.

Lower FX volatility does not necessarily imply a weaker USD

The recent USD weakness appears to be excessive

It is questionable whether there is enough strength in global activity to justify more pronounced USD weakness

What if the Fed eases less than markets currently expect?

Disclosure appendix

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