FX Viewpoint

Currencies
Global

USD credibility issues in focus

- USD weakness has refocused markets on US credibility versus peers, especially the JPY
- Softer US data and more dovish Fed pricing have reduced cyclical USD support
- We still expect the USD to recover gradually but risks are rising if these headwinds persist

USD credibility is back in focus

Credibility has become a more prominent theme, particularly for the USD, which has weakened since the last FOMC meeting. This brings us back to our USD framework, assessing the currency through cyclical, structural, and policy factors.

Cyclical support for the USD has faded

Cyclically, **US data has disappointed** since early July while data elsewhere has been firmer, prompting a dovish repricing of Fed expectations alongside a more hawkish repricing for other major central banks. In line with this, the USD Index (DXY) continues to track the 2-year weighted rate differential, **suggesting cyclical support for the USD has deteriorated** and fundamentals are back in focus.

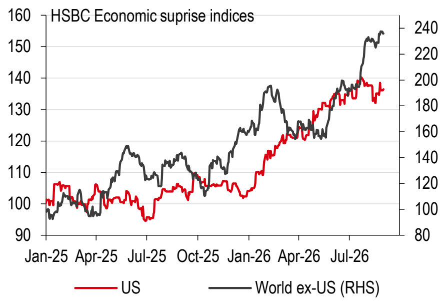
Structural credibility questions are rising

Structurally, uncertainty around the Fed's reaction function and widening fiscal deficits has lifted longer-term borrowing costs via a higher "term premium". The Treasury's 19 August buyback operations were seen as a stop-gap, reigniting debate around **macro policy credibility and "USD debasement"**.

Policy risk adds to de-dollarisation narratives

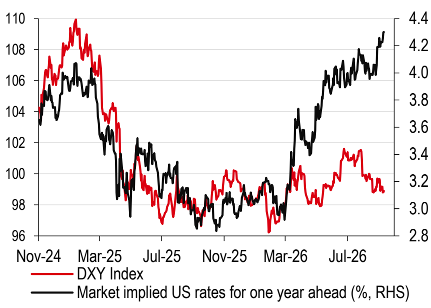
On the policy front, joint intervention to buy JPY has refocused attention on gold as a diversification asset and the "de-dollarisation" theme, while potential new US sanctions on Iran's trade partners may be adding to those concerns.

1. US data has been surprisingly weak while data elsewhere beat expectations



Source: Bloomberg, HSBC

2. The USD Index (DXY) is low versus the level of USD short-term rates



Source: Bloomberg, HSBC

We still expect a gradual USD recovery as EUR and GBP face similar challenges

Overall, markets are looking for a possible shift in perceived credibility between the USD and JPY. Our baseline still expects the **USD to recover gradually**, as the likes of the EUR and GBP face similar credibility challenges, although these are not in the spotlight yet. That said, if our USD framework – cyclical, structural, and political/policy factors – continues to deteriorate, risks to our view rise.

Key near-term events for the USD include the **Fed meetings** on 16 September and 28 October, followed by the **US mid-term elections** on 3 November. For the JPY, attention is on the **Bank of Japan meeting** on 18 September.

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