FX Viewpoint

Currencies
Global

Lower real yields weighing on the USD

- The US Treasury's buyback plan has pressured the USD
- Short-term rates may still matter more than fiscal concerns
- If the Fed stays on hold, near-term USD softness may extend

Lower real yields challenge our view of gradual USD strength

The USD fell to its lowest since May after the US Treasury said on 19 August it will **"at least double" buybacks of long-dated Treasuries** (Bloomberg). While the plan is intended to be liquidity-neutral and funded by short-term bill issuance, markets pushed medium and long-term yields lower and lifted inflation expectations. Lower US real yields pose a **challenge to our mildly bullish USD view**.

We see the near-term USD trend driven by cyclical factors

The US yield curve has steepened recently, which is often associated with a weaker USD (Chart 1); since the 29 July FOMC meeting, the US Dollar index (DXY) is down c2.5%. Despite renewed focus on long-term rates, **we still see the near-term USD outlook as mainly cyclical**, although structural questions are starting to emerge.

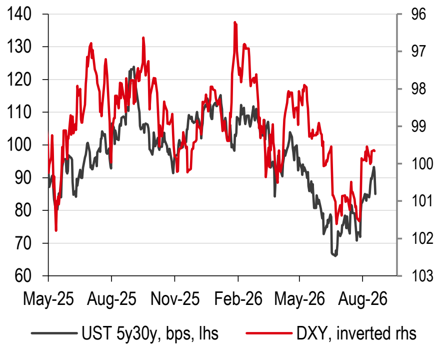
Short-term interest rates are likely still the key driver

We think **short-term rate differentials remain the key driver:** since April, EUR-USD has tracked the Eurozone-US 2-year rate spread. US 2-year yields have fallen versus the Eurozone as markets have pared back hawkish Fed expectations amid softer US data. In contrast, the ECB has stayed relatively hawkish (June hike; markets pricing a high chance of a September hike), while stronger PMIs and Brent above USD90 per barrel **have also lifted Eurozone yields, supporting the EUR**.

Eurozone rates have moved closer to those in the US

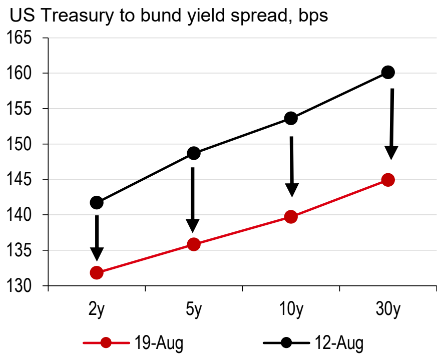
Meanwhile, long-term yields have risen across developed markets. If fiscal concerns were dominant, EUR and especially GBP would likely face similar pressure. Instead, European yield curves have also shifted higher, **keeping rate differentials closer to the US** (Chart 2), though they may be vulnerable if growth disappoints.

1. USD Index (DXY) usually weakens when the US curve steepens



Source: HSBC, Bloomberg

2. European yields are up across, narrowing spreads to US Treasuries



Source: HSBC, Bloomberg

Near-term USD weakness could extend if the Fed stays on hold

With inflation expectations rising and real yields falling in the US, focus returns to the Fed. The July FOMC minutes show policymakers debating further hikes but not yet agreeing that near-term action is needed. More data will arrive ahead of the September FOMC, and Warsh will speak at Jackson Hole in late August. If the Fed stays on hold, **near-term USD weakness may persist**.

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