Liquid Insight

FX: Upside risks to our bearish USD view

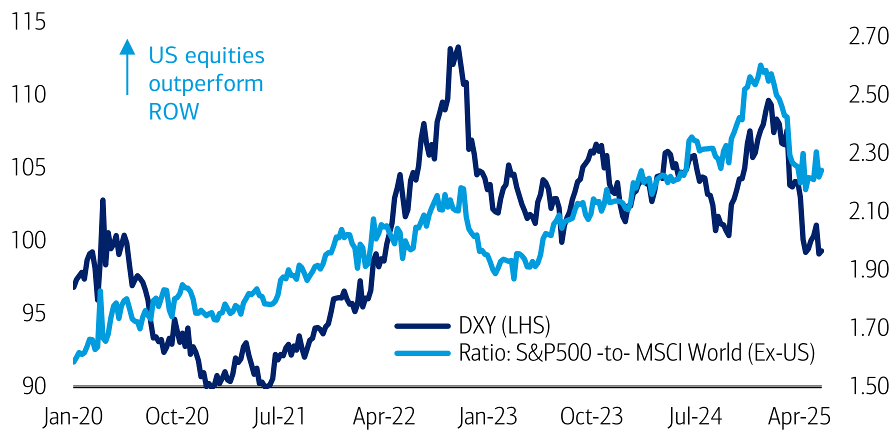
Key takeaways

- We remain bearish on the dollar, but recognize this is becoming an increasingly consensus view, posing risks
- Upside USD risks: ongoing US data resilience, further cooling of trade tensions, & congress finding the fiscal "sweet spot"
- However, we remain cautious, and any near-term dollar rallies more likely to be sold, amid medium/longer term concerns

By Alex Cohen

Chart of the Day: Relative US equity outperformance likely required for an assertive move higher in the USD

Ratio of S&P500 -to- MSCI World (ex-US) vs. the DXY index



Source: Bloomberg; BofA Global Research

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Assessing upside USD risks

We remain core dollar bears, but near-term upside risks cannot be ignored. Market narratives regarding the impact of tariff and fiscal uncertainty are well developed, and negative risk premia remains embedded in the dollar. Finding the fiscal "sweet spot" remains challenging but not impossible for Congress, and the Administration may be incentivized to ultimately lower the temperature on the trade war even further. That said, the most likely near-term catalyst for USD upside lies in the ongoing US data resilience or even a reacceleration, even if temporary. Still, we view the longer-term impacts of a US-induced global trade war as ultimately keeping the USD as the main relief valve for the economy, especially from a starting point of elevated valuations. We would expect any near-term USD rallies to ultimately be seen as selling opportunities, barring major policy and economic shifts.

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Core Bearish USD View Unchanged

As most recently covered in our report USD: Still bearish after all these months 15 May 2025, we continue to expect the USD to depreciate broadly this year, though recognize that this is increasingly becoming a consensus view. Our core bearish USD view is ultimately predicated on the following:

1. Business uncertainty remains relatively high as the ultimate impact of tariffs has yet to be realized. Tariffs— even if watered down— represent stagflationary risks to the US economy, leading to sub-optimal outcomes to be expressed in negative risk premia. (see report: USD on edge 29 May 2025)

2. Global real-money asset allocators and FX risk managers have found themselves overweight USD exposure in the post-COVID era. US policy has forced a collective reassessment of this, and the long and slow process of reducing USD exposure on a large pool of under-hedged asset holdings is just getting started. (see report: Swimming USD-naked as the tide goes out 14 April 2025)

3. The US Administration has an apparent preference for a weaker USD and lower rates. Contemplating policies such as “section 899” in the fiscal bill, as an example, further underscore the desire to deflect capital from flowing to the US. Reduced trade deficits mechanically imply a weaker dollar to attract foreign capital. (see report: Unintended consequences of US trade policy 28 May 2025; FX and fiscal policy enter the chat 22 May 2025)

That said, the US economy continues to demonstrate resilience and peak-tariff uncertainty is arguably in the rear-view mirror. Amid this seeming lack of fresh theme/catalysts, it is natural to contemplate where the risks to our view could lie. Here we discuss three possible factors that pose upside dollar risks, even if only as a tactical pullback in a longer downtrend.

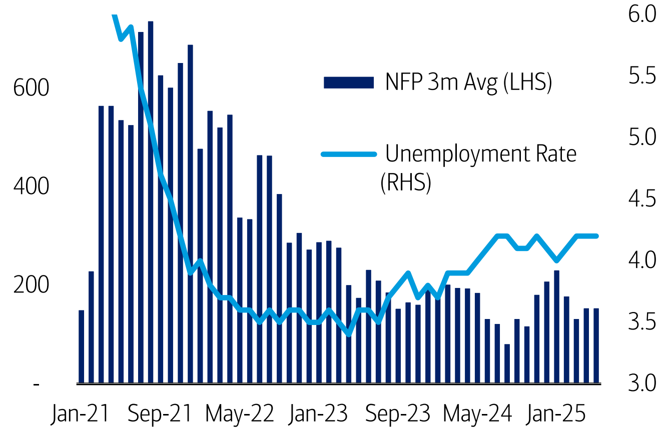
USD Upside Risk #1: US data resiliency continues, evolves to reacceleration

The single biggest factor supporting the dollar from further declines is the ongoing signs of US economic resilience. The “outperformance” of the US hard data over soft data has been widely covered, with the unemployment still not breaching 4.3% amid steady and healthy monthly NFP additions (Exhibit 2). Inflation remains above target, and the Fed seems comfortable with its patient stance, as the tariff impact on prices remains in the pipeline. The dollar has notably underperformed rate differentials, and at some point, investors could look to fade this deviation, absent further economic softening. This would be especially true in a scenario where Fed repricing morphed from the gradual pushing back of the next cut, to a more impactful elevating of the expected rate trough. Friday’s employment report could be pivotal here.

Why we remain cautious

While US data has been resilient, it has not really been dramatically improving either. The often referred to “low hire/low fire” labor market is still clearly more vulnerable than it was in the 2022/2023 timeframe when job seekers had significantly more leverage. This is most clearly reflected in the ongoing rise in continuing claims, while the job opening rate continues to slowly trend lower. (Exhibit 3) Meanwhile, signs of tariff front-loading suggest backward-looking data could be obsolete for the next few months. The reason this has yet to benefit the USD stems from the more forward-looking nature of the FX market, where the dollar struggles to forcibly rally ahead of eventual rate cuts.

Exhibit 1: US labor conditions remain solid overall....
Unemployment rate & NFP (3wk average)



Source: Bloomberg; BofA Global Research

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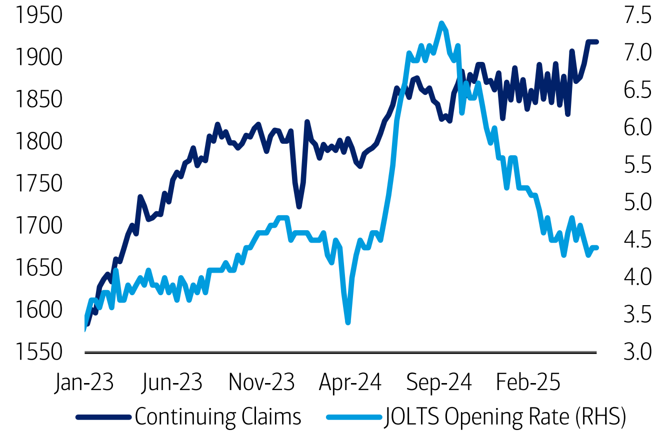
Exhibit 2: ...Though job openings are trending lower as claims tick higher
Continuing unemployment claims & JOLTS openings rate



Source: Bloomberg; BofA Global Research

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USD Upside Risk #2: Further tariff moderation

With the 90-day pause on Liberation Day tariffs now almost a month away, the Administration will likely be looking to announce additional trade deals relatively soon. Thus far, the UK deal was seen as more "low hanging fruit" than anything that required difficult negotiations and/or concessions favoring the US. While it yet to be seen if this will be used as a template for others (given the structurally different UK-US trade balance compared to other large economies), the general trend has been for the more hawkish trade rhetoric to be walked back in short order. It is reasonable to presume that we are past peak-trade uncertainty, as has been reflected in the more-than-full equity recovery post-"Liberation Day". That said, the recovery has been global, and further USD upside likely could depend on a reassertion of US "outperformance", to mark some return to the exceptionalism theme. (Chart of the Day)

Why we remain cautious

That said, the more difficult negotiations with the likes of the Euro Area and China remain an unknown. Overall, the impact that more recent trade developments have had on the market has been waning (Exhibit 4), and the USD has not materially benefitted from any signs of de-escalation. Since tariff policy has been the central policy on the agenda thus far, it is difficult to envision going back to the pre-Liberation Day world, which would be one prerequisite for a more prolonged uptrend in the USD to form.

Exhibit 4: Impact of tariff headlines has been waning as investors seek fresh catalysts
Key Tariff related events: 1-day impact on key assets

Date	Event	BBDXY (%)	BBDXY 3m Imp Vol (ppt)	S&P 500 (%)	10Y UST (bp)
2-Apr-25	Liberation Day	-1.49%	0.63	-4.84%	10.21
9-Apr-25	90d pause for all ex-China; China tariffs = 145%	-1.82%	0.27	5.73%	-13.20
11-Apr-25	China goes to 125% on US goods	-1.00%	0.66	1.81%	-6.46
8-May-25	US reaches tariff deal with UK	0.38%	-0.61	0.51%	-10.91
11-May-25	US/China agree on 90-day tariff pause	1.03%	-0.78	3.26%	-9.24
23-May-25	US threatens 50% tariff on Europe	-0.78%	0.28	-0.67%	1.77
28-May-25	US announced delay of 50% tariff on Europe	-0.43%	0.06	0.40%	5.93
28-May-25	US Court of International Trade deems tariffs unconstitutional	-0.15%	-0.06	-0.16%	2.56
29-May-25	Federal Appeals Court issues stay on tariffs	-0.36%	-0.02	0.39%	7.69

Source: Bloomberg; BofA Global Research; Red text=escalation, Green text=de-escalation

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USD Upside Risk #3: A fiscal "sweet spot" is achieved

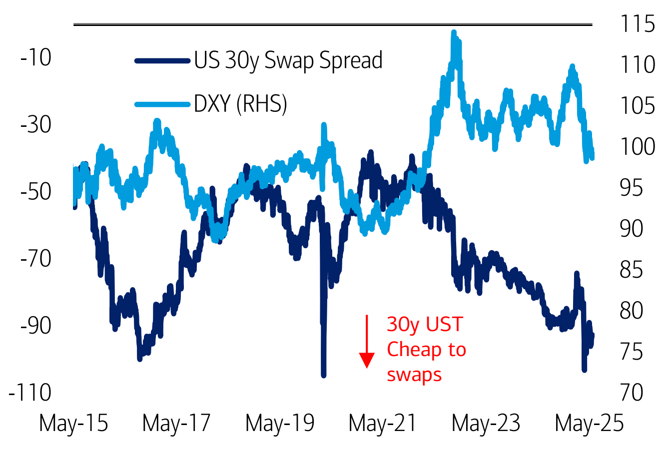
It is an interesting position to now be in where fiscal stimulus is being interpreted as a drag on the USD. The USD's role as the predominant currency at the center of the global financial system affords the US more leeway than other currencies to run sizeable fiscal (and "twin") deficits. Indeed, this was one of the underpinnings of the post-covid/"US exceptionalism" era.

As we noted in the report Bent but not broken: FAQ on the USD's "safe haven" status 08 May 2025, while some damage has been done to the pillars of support to the dollar's unique role, it overall remains well intact. Nevertheless, the fiscal situation is becoming more concerning, as projected deficits continue to grow. With the Senate now poised to make changes to the House's "Big Beautiful Bill", it remains unclear how the presumed final version will shake out. For the dollar, the fiscal "sweet-spot" would be found in a bill that both avoids the automatic tax hikes of the expiring TCJA 2017 taxes, and at the same time introduces more fiscal restraint than exists in the House version. In essence, a bill that both avoids a growth shock while steering the debt trajectory back from and unsustainable path. While this may be difficult to envision, it can't be ruled out.

Why we remain cautious

In the context of a US trade policy that is actively (and mechanically) discouraging capital inflows to the US, concerns over foreign investor demand for US assets are real. Supply and demand dynamics in the long-end of the Treasury curve remain a concern, and our Rates Strategy colleagues continue to see steepening pressure. (Monitoring the likelihood of a late '22 UK dynamic in US rates 28 May 2025) This has manifested in USD weakness, along with the long-end Treasury selloff. (Exhibit 5) Indeed, the dollar's correlation to long-dated swap spread moves has reached extreme levels, further evoking the "sell US" dynamic. (Exhibit 6) Overall fiscal concerns are unlikely to dissipate.

Exhibit 4: USD traditionally moves independent of UST risk premium
DXY & US 30y swap spread



Source: Bloomberg; BofA Global Research

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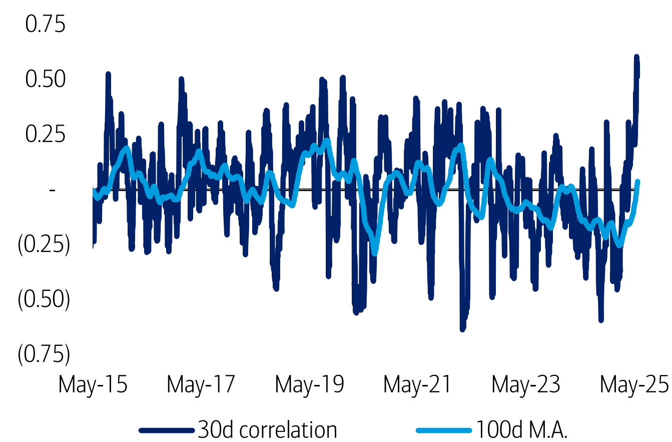
Exhibit 5: USD moves now increasingly correlated to cheapening long-end USTs
Correlation of changes: DXY & 30y swap spread (& 100d moving average)



Source: Bloomberg; BofA Global Research

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Bottom Line

We remain core dollar bears, but near-term upside risks cannot be ignored. Market narratives regarding the impact of tariff and fiscal uncertainty are well developed, and negative risk premia remains embedded in the dollar. Finding the fiscal "sweet spot" remains challenging but not impossible for Congress, and the Administration may be incentivized to ultimately lower the temperature on the trade war. That said, the most likely near-term upside USD risks could manifest in the in ongoing US data resilience or even a reacceleration, even if temporary. Still, we view the longer-term impacts of a US-induced global trade war as ultimately keeping the USD as the main relief valve for the economy, especially from a starting point of elevated valuations. We would expect any near-term USD rallies to ultimately be seen as selling opportunities, barring major policy and economic shifts.

Notable Rates and FX Research

- **Global Macro Year Ahead 2025** – Stretching the rubber band, 24 November 2024
- **Global Rates Year Ahead 2025** – Continental Drift, 24 November 2024
- **G10 FX Year Ahead 2025** – Policy Uncertainty, 26 November 2024
- More USD selling, **Liquid Cross Border Flows**, 27 May 2025

Rates, FX & EM trades for 2025

For a complete list of our open trade recommendations as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Will the US economy keep defying gravity? 30 May 2025

Global Rates Weekly: Legally bond 30 May 2025

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