Daiwa Securities

Daiwa's View

FICC Research Dept

Factors supporting strong dollar are prominent

- Dollar could strengthen further depending on US inflation data

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Daiwa Securities Co. Ltd

Yield, growth, and crude oil are boosting dollar strength

Since the beginning of the year, the 10-year US yield has been on an uptrend, and it reached 4.46% on 8 April. Despite a slight decline from the high it hit on 2 April, the dollar (DXY) has been supported by these movements, remaining at high levels since the beginning of the year, (Chart 1). With stronger-than-expected US economic indicators, the March US jobs report released at the end of last week was very strong.

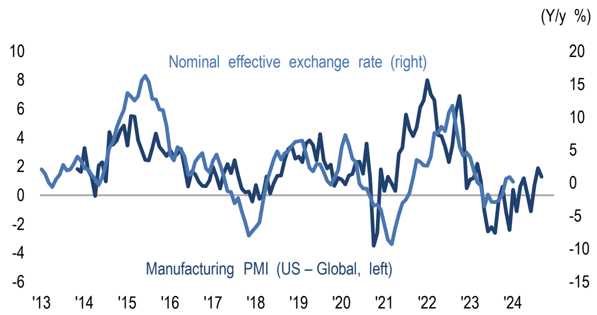
The Global Manufacturing PMI for March rose to 50.6 (from 50.3 in Feb). While the index is still weak compared to the past, it is at its highest level since July 2022. On a 3-month moving average basis, as well, it exceeded 50 and shifted into expansion territory. The March US ISM Manufacturing Index also improved, rising to 50.3 (from 47.8 in Feb), exceeding 50 for the first time in 16 months. This suggests that the long-lasting recession in the US manufacturing sector is coming to an end. On the other hand, the euro zone and other regions are still getting off to a late start. Normally, when the US economy shows this kind of strong growth and is leading the global economy, the dollar tends to strengthen (Chart 2).

Amid the upturn in the global manufacturing cycle, there are also signs of a recovery in China. We saw a rise in both the Caixin- and the government-version Manufacturing PMIs for March, and the government-version reading returned to expansion territory for the first time in five months. With the improvement in demand in the global manufacturing sector and increasing geopolitical risks, including tensions surrounding the situation in the Middle East, crude oil prices are continuing to rise, with the price of Brent crude oil topping $90/bbl. Furthermore, in response to the recovery of the Chinese economy, the price of industrial-use metals, such as copper, has also been rising substantially.

Chart 1: 10yr US Yield, Dollar Index (DXY)

Source: Bloomberg; compiled by Daiwa.

Chart 2: Manufacturing PMI, USD Nominal Effective Exchange Rate



Source: Fed, S&P Global; compiled by Daiwa.
Note: Manufacturing PMI data is plotted 6 months into the future.

The dollar has tended to be correlated with crude oil prices since the beginning of 2023 (Chart 3). While a rise in energy prices improves the terms of trade in the US, it deteriorates the terms of trade in the euro zone and Japan, which tends to create downward pressure on their currencies. High-beta currencies are outperforming due to higher stock prices and resource prices responding to the optimistic outlook for global growth. Yesterday, the AUD/JPY rose to Y100.43, the highest it has reached since November 2014.

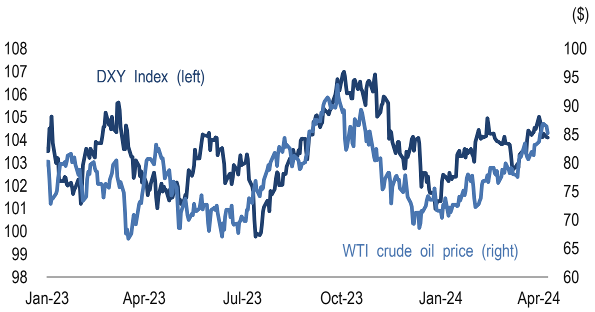
Will the Y152 equilibrium be broken?

Crude oil prices are facing upward pressure from both the demand side and the supply side, and there is a risk that this could delay the disinflation process, even if its impact is not seen immediately. While the strong US jobs report released last week by itself will not prevent a rate cut by the Fed in June, if March US CPI data (due out today) and March PPI data (due out tomorrow) were to be stronger than expected, the validity of three rate cuts in 2024 could be thrown into serious question.

The market's expectations regarding US rate cuts in 2024 have already fallen, with it currently anticipating only about 2.5 rate cuts. The view that there will only be two rate cuts in 2024 could become more predominant depending on the US CPI data to be released today. That said, there is still some time before the June FOMC meeting, so there is no need to abandon the baseline scenario of three rate cuts in 2024 right away. If it is true what Fed Chair Jerome Powell says that "Fed policymakers serve long terms that are not synchronized with election cycles," three rate cuts in 2024 might be possible, even if the rate cuts started in July. Nevertheless, realistically speaking, it is likely that the market's pricing in of rate cuts will diminish gradually.

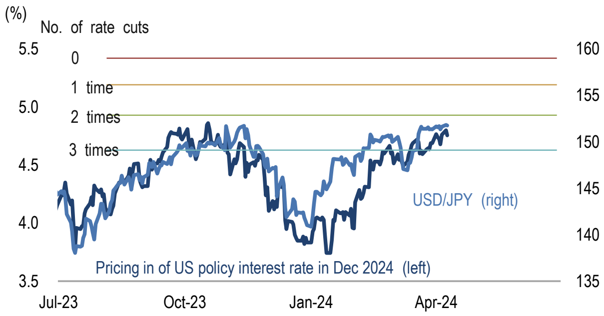
If the number of US rate cuts priced in by the market drops further, the equilibrium with the USD/JPY rate, which has seen a tug-of-war at around Y152, could be broken. The USD/JPY rate has been influenced by the expected number of US rate cuts in 2024. If the number of expected rate cuts were to fall to two, the USD/JPY rate is anticipated to rise above Y152, and if it were to fall to one, the rate is expected to rise above Y155 (Chart 4). BOJ Governor Kazuo Ueda has stated repeatedly that the BOJ would consider responding via monetary policy if exchange rates have a strong impact on economic and price projections. We have to be aware that the timing for additional rate hikes could be moved up if the yen were to weaken significantly. The 10-year BEI in Japan has inched up, clearly exceeding 1.4% recently. It should also be noted that a rate hike to rein in an excessive decline in the real interest rate is now on the horizon.

Chart 3: WTI Crude Oil Price, Dollar Index (DXY)



Source: Bloomberg; compiled by Daiwa.

Chart 4: USD/JPY Rate, Pricing in of FF Rate at end-2024



Source: Bloomberg; compiled by Daiwa.

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