Three calls for FX markets

Our most striking FX call for next year is that 2024 will be the year that the dollar finally turns lower. In our view, the best-performing currencies will be those which are most undervalued – step forward the Australian dollar and the Norwegian krone. And do not expect European currencies to lead the pack

Both the Australian dollar and Norwegian krone are packing undervaluation in their armoury

1 The dollar to turn lower

As we discussed in our 2024 FX Outlook, we think the dollar should be due a cyclical downturn next year. Barring huge and unexpected risk premia emerging in the currency space, the dominant trend should be US growth converging on the weak levels seen in Europe and Asia, the Federal Reserve embarking on an easing cycle, and the dollar falling 5-10%. That view really does hinge on the Fed being able to cut rates and a clean bullish steepening trend playing out in the US yield curve. Typically this coming stage of the economic cycle should see commodity currencies outperform – which fortunately is also one of our calls (see next section). The main threats to our dollar view are enduring US economic strength or another identity crisis in the eurozone – recall EUR/USD failed to rally in 2001, despite the Fed cutting nearly 500bp.

2 The currencies of Australia and Norway to outperform

Fighting the dollar bull trend has been an exercise in futility for most of this year. Currencies prepared to challenge the dollar are going to need some help. And both the Australian dollar and Norwegian krone are packing undervaluation in their armoury. These are the currencies most undervalued according to our medium-term fair value model, where divergence from better export prices is the core story. In effect, the higher US rate environment has prevented these currencies from aligning with the commodity price rally seen in the second half of this year.

3 European currencies set to lag

Unlike the commodity currencies, neither the euro nor the pound are particularly undervalued against the dollar. We do think the dollar story will be enough to drag EUR/USD higher through 2024 – 1.15 is our year-end target – but the moves should be relatively modest. EUR/USD will be trying to rally while the eurozone is in recession. It will also face the challenge of an increasingly dovish European Central Bank, if our call is correct for the first ECB rate cut in June. And weak eurozone growth typically spells trouble for some of the eurozone's peripheral government bond markets too. As to the pound, a 100bp Bank of England easing cycle will create headwinds for GBP/USD. We do not foresee the UK election demanding a big risk premium of the pound, but we doubt it will provide a tailwind either.

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