2024 Currency outlook

Although peaking in 2022, global inflation remained a dominant factor in FX markets in 2023 as central banks grappled with high levels remaining above targets. Following a strong move up on the back of hawkish Fed policy, the US Dollar Index dropped in 2023, marking only its fourth downward year since 2009. As the Russia-Ukraine crisis remains unresolved and the Israel-Hamas conflict raises concerns globally, the uncertainty surrounding these events as well as the outcome of the US election and the risk of recession brings the potential for more market volatility into 2024.

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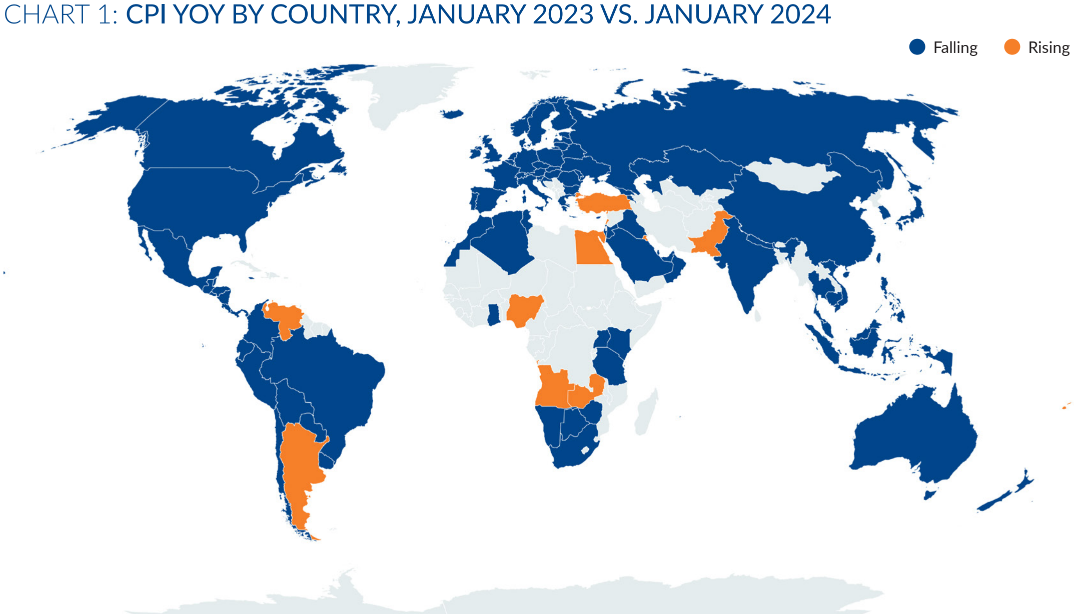
Inflation – Declining while maintaining high levels

With high inflation spanning the globe over the past few years, consumers welcomed falling levels in 2023 as CPI levels dropped globally, with only a few emerging and frontier countries experiencing a higher inflation rate now vs. a year prior (Chart 1).

CHART 1: **CPI YOY BY COUNTRY, JANUARY 2023 VS. JANUARY 2024**



Source: Bloomberg, Mesirow. Past performance is not necessarily indicative of future results. Actual results may materially differ.

> "Among major developed markets, inflation has fallen with a depth of change ranging from 1% to 8%"

Across the major developed markets, inflation has fallen throughout all regions with the depth of change ranging from 1% to 8%. While uniformly lower, existing inflation levels remained elevated with only Denmark and Switzerland ending the year with CPI below 2% YoY (Chart 2).

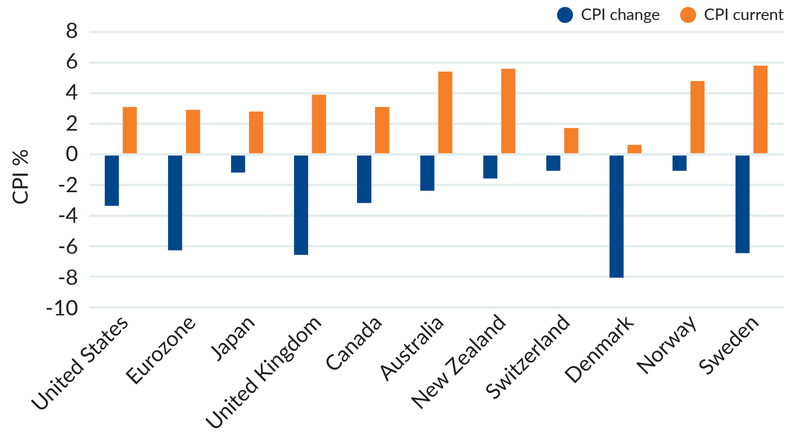
Inflation reached its peak globally mid-2022 as central banks began a mostly uniform hiking schedule across developed nations. Although inflation reversed course, the hiking schedule continued into 2023. The central bank response was reactionary, lagging inflation prints with rate hikes continuing to ascend after inflation peaked. Hawkish policy continued as the fight against inflation persisted globally as levels remained above most regions' targets, commonly around the 2% level although targets vary between countries (Chart 3).

US dollar weakness over higher-for-longer policy

Following significant strength in 2022, the US dollar ended the year weaker with the US dollar index down over -2% in 2023. As noted in last year's outlook, spiking US CPI was followed by a soaring US dollar, with price action heavily influenced by central bank policy in response to inflation. However, with the Fed following a higher-for-longer hawkish policy, increasing FOMC interest rates did not correspond with a stronger US dollar in 2023 but instead found pockets of weakness. When US inflation turned lower, the US dollar eventually followed suit by weakening although rates were still on the rise. US dollar movements were more in-sync with implied market rate expectations than current rates, with the US dollar index tracking more closely with 1Y implied rates vs. actual central bank rates (Chart 4).

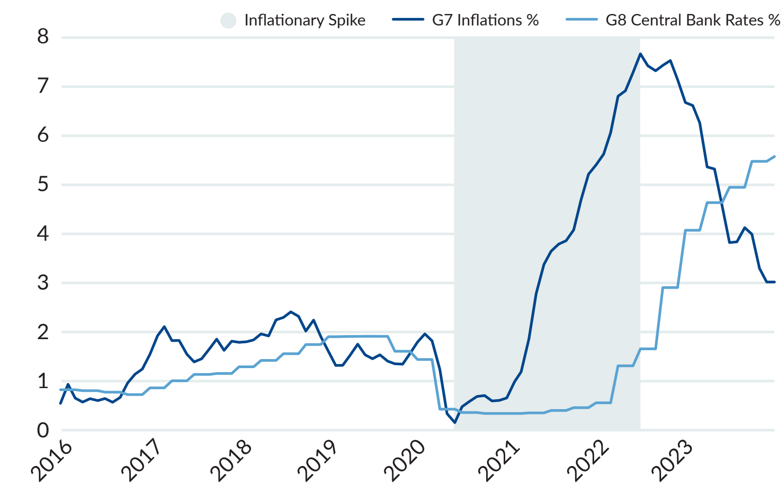
Fed rates lagged US dollar price action as the consequence of tightening had not been felt yet by the economy. Implied rates reflected market sentiment through the expectation of lower rates in the future, and thus tracked the US dollar index well through this inflationary period.

CHART 2: CPI YOY, JANUARY 2024



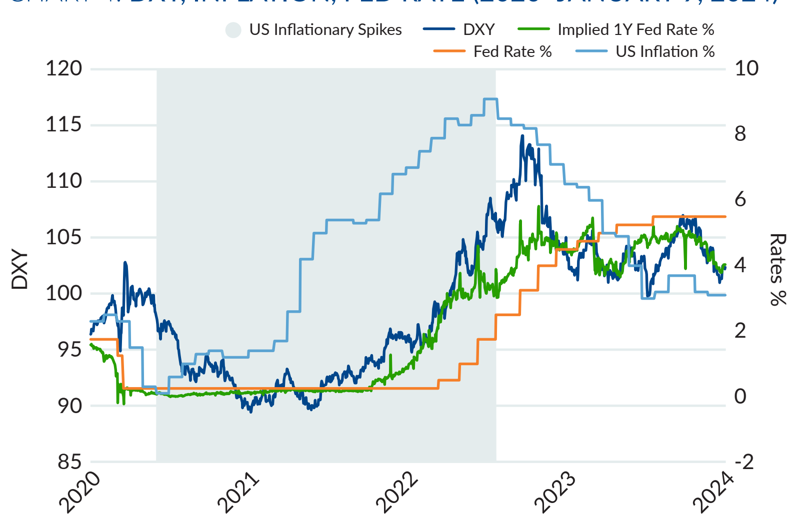
Source: Bloomberg, Mesirow, Past performance is not necessarily indicative of future results. Actual results may materially differ.

CHART 3: DEVELOPED MARKETS INFLATION AND CENTRAL BANK RATES (2016–2023)



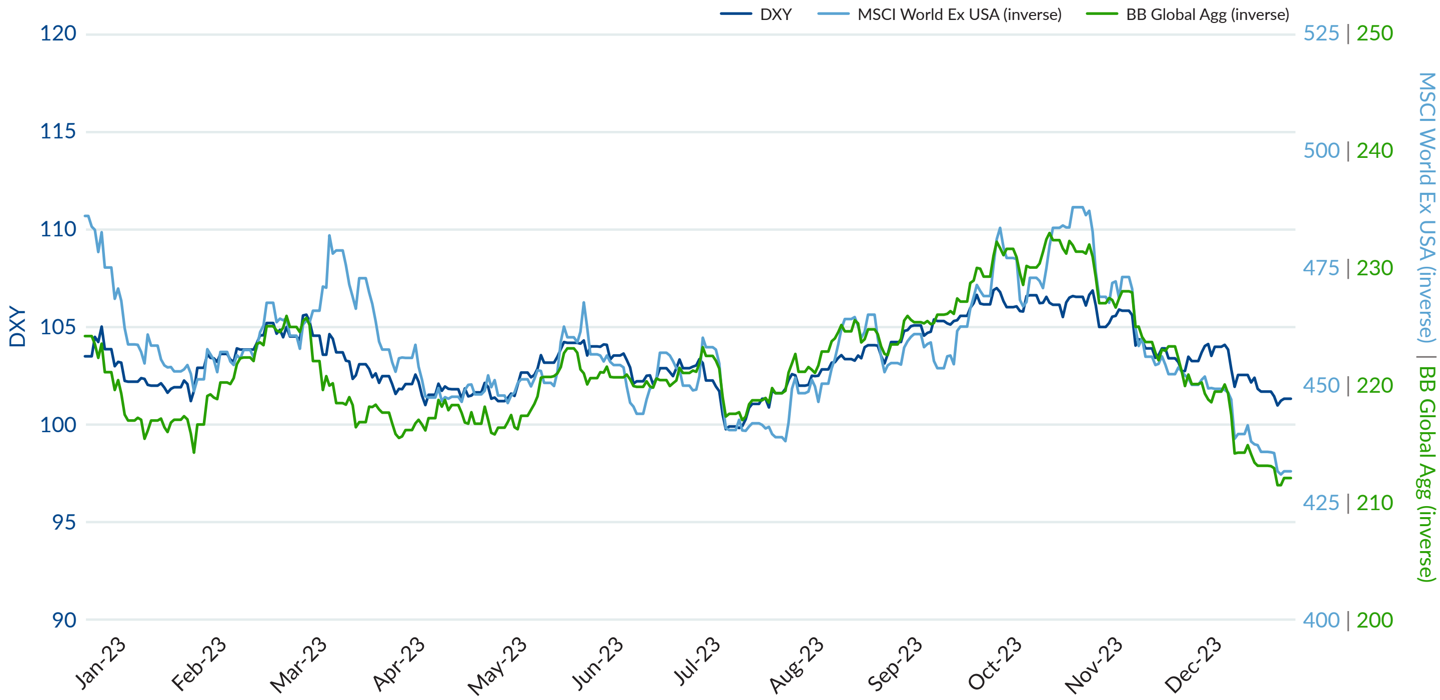
Source: Bloomberg, Mesirow. Past performance is not necessarily indicative of future results. Actual results may materially differ.

CHART 4: DXY, INFLATION, FED RATE (2020–JANUARY 9, 2024)



Source: Bloomberg, Mesirow. Past performance is not necessarily indicative of future results. Actual results may materially differ.

CHART 5: **DXY, EQUITIES, FIXED INCOME (JANUARY 2023–DECEMBER 2023)**



Source: Bloomberg, Mesirow. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Market risk and the US dollar

The safe-haven characteristics of the US dollar were on full-display over the past year, as risk-on / risk-off market backdrops caused episodic flights-to-safety. Various risk events throughout the year led to the fluctuations within US dollar: the ongoing Russia-Ukraine war, crises among both US and Swiss banks, wildfires in Hawaii and Canada, union strikes from autoworkers to actors & writers, and the Israel-Hamas war. Using the MSCI World Ex USA equity index as a proxy for risk sentiment, the inverse of risk tracked the US dollar index well as US dollar appreciated during risky periods and dropped when risk appetite recovered (Chart 5).

Interesting to note from a portfolio perspective, while equities and fixed income have historically benefited from diversification between asset classes, the correlated behavior seen at the end of 2022 when both asset classes fell simultaneously, continued in 2023. Both the inverse of the equities (MSCI World Ex USA) and the inverse of fixed income (Bloomberg Global Aggregate) tracked the oscillating behavior of the US dollar index this past year (Chart 5).

Conclusion

As we move into 2024, several risk factors remain in play that could have major influence on the US dollar, starting with the realization of rate cuts following an historic period of rate hikes. The balance between inflationary pressures and recession remains at the crux of central bank policy. With the majority of investors expecting rate cuts this year, balancing those cuts against the possibility of reigniting inflation is a delicate juggling act. Though the Fed is widely expected to begin cutting rates in 2024, market expectations predict a much steeper rate drop this year than do the dot plot projections of the Fed. Although the December 2023 dot plot reflected more a more dovish outlook than September's, the median 75bps of cuts in 2024 falls short of market implied cuts of approximately 140bps by the December meeting (Source: Bloomberg). The actual pace of cuts will influence US dollar behavior, with risk towards hawkish surprises as dovish expectations are currently priced in.

With the recent risk-sensitive behavior of the US dollar, risk events continue to bring uncertainty and market volatility. With the Russia-Ukraine war and the Israel-Hamas crisis continuing into 2024, the sensitivity towards financial risks remains high. The initial effects on oil and gas have been contained and short-lived so far, as prices have generally fallen along with inflation and commodities in general.

However, the effect of the conflicts on the global economy has not been realized should other nations become embroiled in any escalation.

With the Silicon Valley Bank collapse in March followed by the failure of other smaller regional banks, banking fears gripped the markets, spreading to Switzerland as Credit Suisse was bought by UBS in an emergency arrangement brokered by the Swiss government. Contagion has been relatively contained in the aftermath, as major central banks announced liquidity measures to calm the markets. While still an active source of risk that could lead to flights-to-safety, anticipated interest rate cuts globally could help alleviate tighter financial conditions in the new year.

The largest anticipated US-centric event in 2024 is the presidential and congressional election, likely to dominate the attention of the US population as well as capture a global audience, and consequently affect financial markets as voter sentiment evolves throughout the year. The ramifications affect geopolitics and global economies with repercussions that are hard to predict, thus promoting high risk sensitivity throughout the election process.

With known and unknown risk events on the horizon, preparing beforehand for potential market impacts is of utmost importance. We recommend that institutions have a currency hedging policy firmly in place prior to unexpected events to responsibly manage currency risk in their international exposures.

From all of us at Mesirow Currency Management, may the coming year bring joy, prosperity, and good health.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

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