HSBC Global Research

15 September 2021

Reflex reactions in FX

RORO's grip on the USD has slipped

Currencies
Global

- The immediate reaction of the FX market to US economic data shows the grip of RORO has loosened markedly
- Our updated DRIVERS signal shows only 25% of USD reactions in the last 4 weeks displayed a RORO personality
- The Fed's taper discussion is transforming the personality of the USD reflex into one dominated by the US cycle

Daragh Maher
Head of Research, Americas/Head of FX Strategy, US
HSBC Securities (USA) Inc.
daragh.maher@us.hsbc.com
+1 212 525 4114

Paul Mackel
Global Head of FX Research
The Hongkong and Shanghai Banking Corporation Limited
paulmackel@hsbc.com.hk
+852 2996 6565

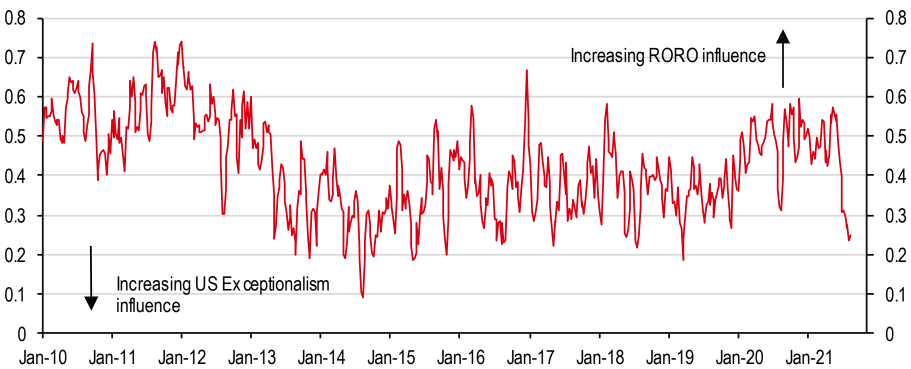
Mark McDonald
Head of Data Science and Analytics
HSBC Bank plc
mark.mcdonald@hsbcib.com
+44 20 7991 5966

Molly McGown, CFA
Data Scientist
HSBC Securities (USA) Inc.
molly.mcgown@us.hsbc.com
+1 212 525 3161

To determine whether the USD is driven more by risk appetite or US cyclical considerations, we created our DRIVERS indicator[1]. We measured the directional response of the dollar to US data surprises in the first minute after the economic release compared to the level a minute before the release. If the USD response is in the same direction as the surprise, it is a response driven by the US cycle, while if they are in opposite directions, this is a "risk on-risk off" (RORO) response. The higher the DRIVERS indicator, the more influential RORO is relative to US cyclical considerations.

While our original indicator was on a lookback period of 12-weeks, we extended our original analysis to include a shorter 4-week window. This provides a more timely measure of dollar personality shifts, including the one currently underway. In the past four weeks, only 25% of USD responses were risk-off, a notable shift from the 50-60% level seen ahead of the June FOMC. Since then, RORO's grip on the USD reaction has been on the retreat as the Fed and taper timing dominate the narrative. However, if we look beyond the reflex reaction, RORO has not disappeared entirely.

1. HSBC's DRIVERS index (4-week window) has dropped sharply recently



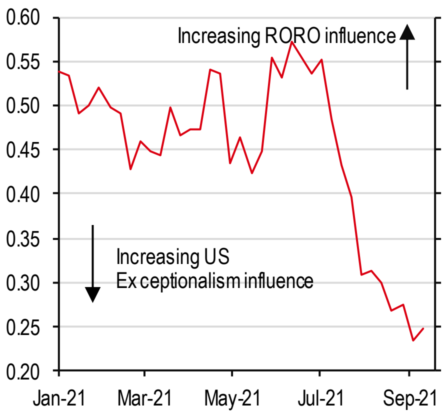
Source: HSBC, Bloomberg

1 See *USD Mood Swings* (1 March 2021) for more details

Since the initial publication of our DRIVERS indicator in March this year[2], we have already examined whether confining the analysis to only large US data surprises or expanding the reaction time period to three minutes rather than one would have a bearing on the results. Neither modification was impactful, so we stuck with the original methodology[3].

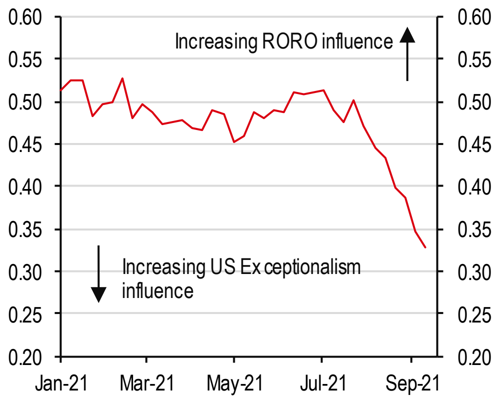
In this report, however, we introduce an alternative reference time-frame for the DRIVERS signal of a rolling 4-week window, rather than 12, and it is proving quite illuminating currently. We chose four weeks as we wanted a smaller, more nimble signal, but one which would still encompass all of the US economic activity releases and so retain its accuracy regarding the personality of the USD.

2. DRIVERS with a 4-week window



Source: HSBC, Bloomberg

3. DRIVERS with a 12-week window



Source: HSBC, Bloomberg

In the last month, there has been a rapid loosening of RORO's grip on the USD. With the frequency of discussion of Fed tapering increasing over that period[4], it is clear that USD investors are growing more and more concerned with the future of Fed bond purchases and ultimately the timing of rate hikes. Indeed, the shift towards a Fed-dominated dollar followed swiftly after the June FOMC. Only four other instances over the 11-year window of our DRIVERS signal show a drop as quickly as seen in the past 10 weeks.

The upcoming September FOMC, with its new dots plot and perhaps some insight into the make-up of tapering, suggests the reflex reaction of the USD to data is likely to remain US cyclically focused. Additional uncertainty comes from the Delta variant and the potential impacts that it brings to the US economy and monetary policy.

Looking beyond the reflex reaction

Even though the Fed and US cyclical considerations currently have a larger grip on USD reactions, this does not mean RORO responses are entirely a thing of the past. In our analysis, we look only at US data surprises, and ignore all other market variables that impact the currency. We are also looking only at the 1-minute reflex response following an economic release.

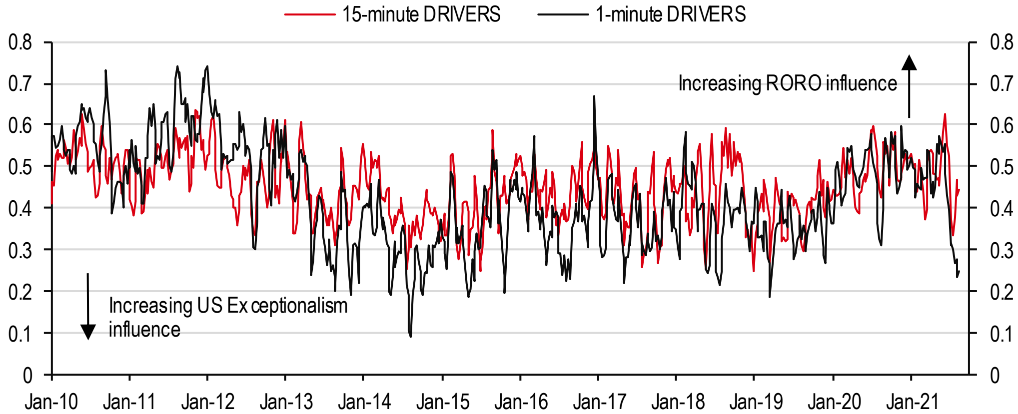
Interestingly, when looking at recent large negative surprises, we expected to see evidence of more risk-off moves based on how the USD has behaved. However, we saw that for most currency pairs involved in our indicator, specifically for the larger surprises in Retail Sales, Michigan Consumer Confidence, and New Housing Starts, for the first minute after the release

2 See *USD mood swings*, 1 March 2021
3 See *Revisiting the moody USD*, 9 March 2021
4 See *Focussed on taper talk*, 17 August 2021

they exhibit negative dollar returns in response to these negative events, followed by a reversal towards a RORO USD reaction thereafter.

This is captured if we look at “slow” DRIVERS, where we measure the USD reaction after a 15-minute window (see Chart 4). While choosing 15-minutes may be somewhat arbitrary, we needed to look at a window not too long to have been overcome by other market events, but not too short to miss out on any reversal actions. 15-minutes seemed appropriate and was able to capture the sample of reaction reversals that we investigated

4. Risk-off reaction function more evident 15-minutes after the economic data release



Source: HSBC, Bloomberg

We can see that these two measures generally follow each other, at least directionally, but there are times of divergence. Specifically, in the last month we see a steep decline in our 1-minute DRIVERS signal, while the 15-minute signal remains relatively steady and suggestive of RORO still being influential. While the “slow” DRIVERS measure is still not far off 50:50 (which suggests a finely balanced debate on first look), this is a reasonably high value for RORO influence by historic standards. Looking at the history of DRIVERS, the default more often seems to be that the USD moves in the same direction as the surprise, with RORO sometimes increasing its influence to make it closer to a 50:50 outcome.

While there is nothing specific to point to in causing the recent divergent behavior between the 1-minute and 15-minute signals recently or historically, it seems the FX market cannot help but look to risk appetite for direction after the initial reflex reaction.

With the rapidly changing market, a 4-week window of our indicator will continue to provide more timely measures of the USD’s reaction function. Additionally, the 15-minute reaction allows us to see if the reflex move is being echoed in the subsequent market move. With the Fed in the midst of its policy transition, gauging the personality of the USD will be a crucial element in driving any USD forecast.