FX Strategy

Turning strategically negative DXY and positive JPY

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Strategically, we switch to a NEGATIVE position on DXY *(from NEUTRAL), as the macroeconomic and monetary policy outlook, as well as policy and fiscal uncertainty. should weigh on the USD performance in the medium-term.*

According to our BEER model, the EUR is overvalued. This, coupled with expectations of continued disinflation in 2027, a possible dovish shift by the ECB in H2 2027, and political uncertainty (especially in anticipation of French and Italian elections) should weigh on the common currency.
Against this backdrop, ***we remain strategically NEUTRAL on EUR-USD****, as we believe that, in the medium-term, the negative factors for the EUR and the USD may offset each other.*

We think that the tide has turned on the JPY, as the BoJ has turned more hawkish, there is a strong political willingness to defend the yen, and the probability of repatriation is now higher than in the previous months. Against this backdrop, ***we strategically position ourselves short on USD-JPY.***

Taking stock of our strategic FX positions

Starting from our new ANIMA BEER model (see the Appendix for the details on the model), we take stock of our strategic FX views.
Strategically, we switch to a NEGATIVE position on DXY (from NEUTRAL), while we remain strategically NEUTRAL on EUR-USD, as we believe that, in the medium term, the negative factors for the EUR and the USD may offset each other.
We think that the tide has turned on the yen, and **we strategically position ourselves short on USD-JPY.**

DXY: Moderately negative forces are re-emerging

After being supported by an improvement in the terms of trade since the start of the Middle East conflict, the USD has shown a more mixed performance in recent weeks.
Our ANIMA BEER model[1] indicates that the USD has been tracking quite closely to our model equilibrium in recent quarters and is now broadly in line with the model equilibrium (Figure 1).
We think that, in the medium-term, the balance of risks is skewed towards a moderately weaker dollar, for the following reasons:

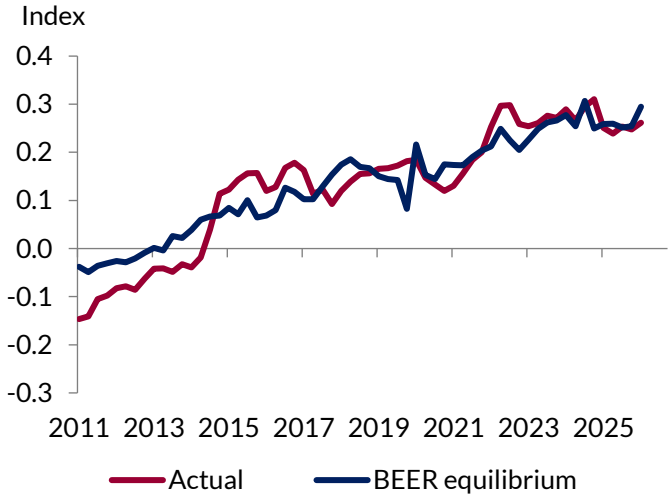
1) Middle-East war support for the USD is fading

From the start of the Middle East conflict in May through June/July the main driver of USD performance was the improvement in terms of trade coming from higher energy prices. Against this backdrop, the USD also worked as a hedge for equity exposure. From June/July, however, the USD started to be driven again by interest rate differentials, as well as the resurgence of a political risk premium (Figure 2). **With the Middle-East conflict dragging on, we expect the improvement in terms of trade to weaken further as a driver of the USD, failing to provide much support going forward. In the medium-term, a possible end to the Middle East conflict would also moderately weigh on the USD via the worsening of terms of trade.**

[1] *See Appendix for more insights on the ANIMA BEER model.*

Figure 1

USD is trading broadly in line with its equilibrium



Please see the Appendix for a technical explanation of the ANIMA BEER model.

Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 2

EUR-USD less sensitive to oil prices

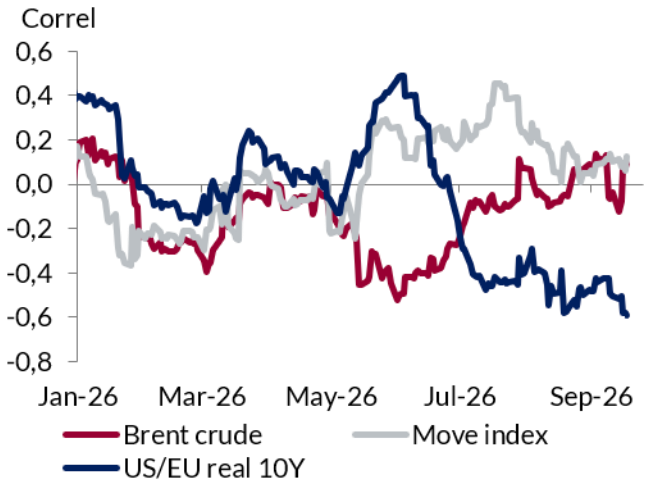


Chart shows the 30-days rolling correlation of daily changes in the variables with daily changes in the EUR-USD

Source: Bloomberg, Haver Analytics, ANIMA Research

2) Macroeconomic outlook to remain solid, but growth should moderate

US GDP growth proved resilient but not overheated in 2026, running modestly above its potential rate. Looking ahead to 2027, we expect the macroeconomic backdrop to remain largely unchanged, although growth is likely to shift from the upper end of potential to the lower end of the range. On the one hand, support from non-AI capex is likely to fade as the investment incentives embedded in the One Big Beautiful Bill Act (OBBBA) gradually lose traction.

Moreover, with the boost from the OBBBA largely fading by year-end, fiscal policy is set to transition from a source of support to a modest headwind in 2027.

At the same time, we expect the process of disinflation to continue in the coming months, with core PCE reaching its target in H2 2027.

With reference to the ANIMA BEER model, the performance of labour productivity is likely to remain highly uncertain in the next quarters, given that the jury is still out on whether AI will be able to boost productivity relatively soon.

All in all, we think that our baseline macro scenario is consistent with a slightly weaker dollar.

3) Market pricing of the Fed is too hawkish

While Chair Warsh has so far communicated through a hawkish rhetoric and raising rates at the September meeting, we think that 1) market pricing of the Fed is too hawkish, as also suggested by the September dot plot and 2) that in the Fed's September Summary of Economic Projections, growth projections are too optimistic and inflation forecasts are too high. Against this backdrop, we see the possibility that next year, he will soften his rhetoric as soon as he is reasonably sure that the underlying trend in inflation is moderating.

4) The fiscal outlook will remain a drag

While we believe that the fiscal outlook would not have emerged as an issue for investors had Chair Warsh clarified its reaction function and had the administration not engaged in unorthodox policies on all fronts, **we think investors will keep this theme at the back of their minds from now on**. As we have observed after the announcement of the increase in buyback amounts by Secretary Bessent, even intervention to contain the selling pressure at the long-end of the curve weighs negatively on the dollar, not through the traditional interest-rate differential channel (the intervention did not lead to lower long-end yields), but through the fiscal credibility/political uncertainty channel (Figure 3).

5) Policy uncertainty may remain a driver even after the mid-term elections (via hedging activity)

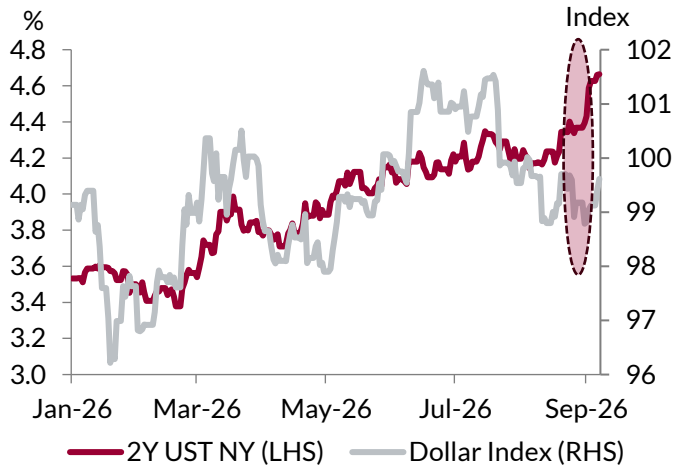
Since Liberation day in April 2025, a rising political premium has triggered a sharp decline in the USD, which moved to a lower trading range compared to the pre-Trump period. This move did not reflect a broad-based loss of confidence in dollar assets, but rather a more uncertain outlook in terms of domestic and external policies that led to increased hedging activity by foreign investors who had unhedged exposure to dollar assets[2]. Policy uncertainty has also been reflected in rates markets via a higher term premium that is not justified by traditional drivers (rates volatility, inflation uncertainty, economic cycle and free-float of USTs). Figure 4 shows that since Liberation day, the increase in the term premium led by the political uncertainty component was associated with a weakening of the dollar.

The mid-term elections might lead to a moderate decline in the political uncertainty premium embedded in the dollar and we think that the Fed's September move has re-established some order in the chaotic response of the Trump administration to the rise in yields, especially at the long-end. That said, we believe that only a commitment by the administration to be more fiscally responsible and a very clear reaction function by the Fed after the outcome of the various task forces appointed by Chair Warsh have been discussed, could lead to a complete wipe-out of this premium. Meanwhile, **we expect hedging activity on exposure to dollar assets by foreigners (especially bond holders) to continue.** For reference, Bloomberg estimates that hedged exposure for Canada, Denmark, Australia, Taiwan, Japan and Finland major institutional investors amounts to around 40% and has steadily declined over the last few years, with just a break in the trend in 2025, post Liberation day, when the ratio went up to 44%.

[2] *Most investors in dollar assets held unhedged exposures given the dollar performance and the cost of hedging. See BIS Bulletin No 105, "US Dollar's Slide in April 2025: The Role of FX Hedging", by Hyun Song Shin, Philip Wooldridge and Dora Xia* https://www.bis.org/publications/bulletin-105-us-dollars-slide-april-2025-role-fx-hedging.pdf

Figure 3

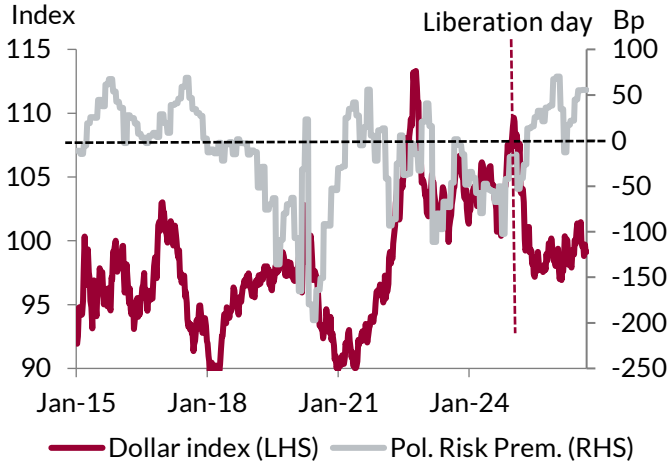
Bessent broke the correlation between yields and DXY



Source: Bloomberg, ANIMA Research

Figure 4

USD weakened with the increase in political risk



Political risk premium is the residual of a regression of 10Y term premium on unemployment rate, inflation risk premium, rates volatility and free-float of USTs.

Source: Bloomberg, ANIMA Research

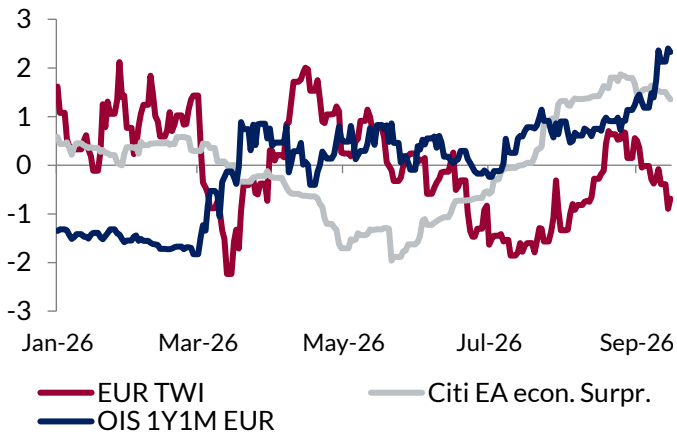
EUR: Positive factors have been almost entirely priced in

Since the end of July and until the start of September, the EUR has appreciated against most currencies on a combination of positive economic surprises and an upward revision of monetary policy expectations, especially at the 6M+ horizon (Figure 5). From a more medium-term perspective, our ANIMA BEER model [3] shows that the EUR real exchange rate is around 7% overvalued (Figure 6). Interestingly, the overvaluation of the EUR started building around March/April 2025. We think that part of it was due to markets' enthusiasm for the German fiscal package, and part was due to political uncertainty in the US, which led to a decline in the USD probably benefiting the EUR. Taking stock of the indications from our BEER model and of a few other reasons explained below, **we think that, in the medium-term, the balance of risks is skewed towards a weaker EUR**.

[3] *See Appendix for more insights on the ANIMA BEER model.*

Figure 5

EUR supported in the summer by monetary policy expectations and stronger economic data

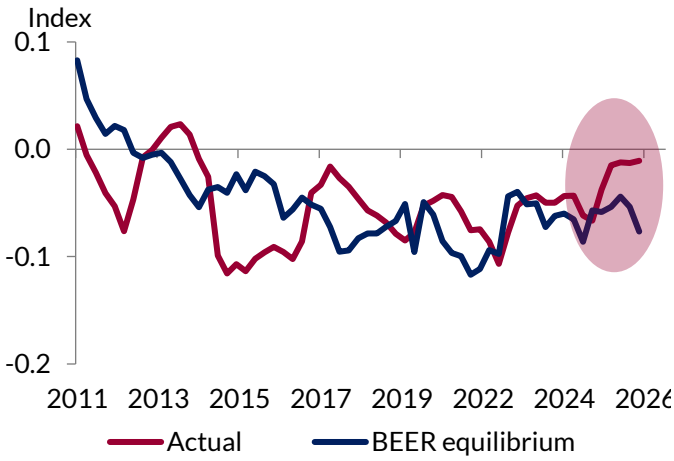


All values are normalized

Source: Bloomberg, ANIMA Research

Figure 6

EUR 7% overvalued vs. ANIMA BEER equilibrium



Please see the Appendix for a technical explanation of the ANIMA BEER model.

Source: Bloomberg, Haver Analytics, ANIMA Research

1) Most of the positive factors have been priced in, while the negative factors have been ignored

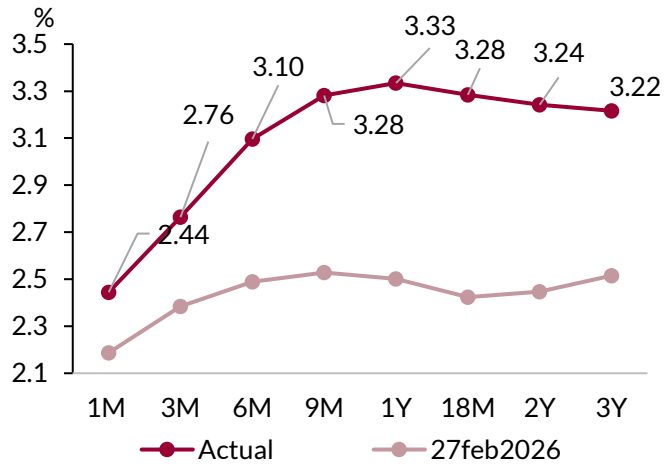
Like for Bunds, **we think that most of the positive factors (both cyclical and structural) are already priced into the EUR, while the EUR has not priced in the negative (both cyclical and structural) factors**. Our ANIMA BEER model indicates that the EUR should have been much weaker at this point due to 1) stalling labour productivity and 2) more recently, to a worsening in the terms of trade (Figure 6). On the other hand, the surprisingly resilient EA economy during the Middle East conflict, combined with optimism about the progress of German reforms and German spending on defence and infrastructure, and with a general negative sentiment towards the USD, has supported the EUR.

1) We expect the ECB to deliver two rate cuts in H2 2027

We think market pricing for the ECB is excessively hawkish, with the terminal rate now priced at well over 3% (depo rate) and no cuts priced over a 3Y horizon (Figure 7). We expect the disinflation trend, especially in the services component, to accelerate in 2027, while growth should remain resilient but below potential. Moreover, in the case of energy prices remaining near their top levels for a prolonged period of time, we expect the tightening of financing conditions coming from rising real yields and the high energy prices to lead to a slow-down in growth. Against this backdrop, we expect the ECB to get the depo rate back to the 2% area in H2 2027. This would be a EUR negative factor.

Figure 7

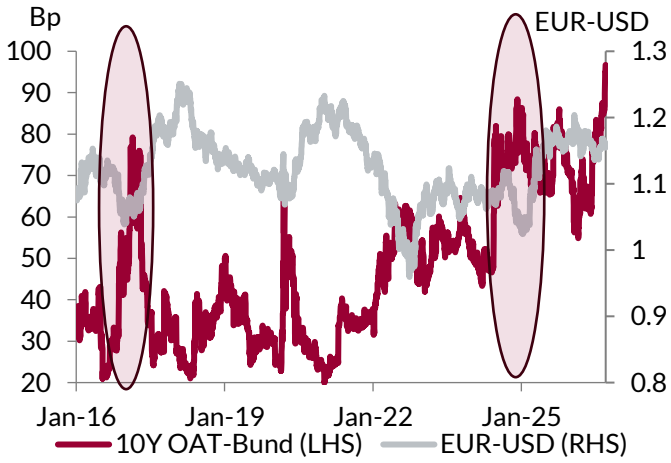
Very hawkish monetary policy expectations on ECB



Source: Bloomberg, ANIMA Research

Figure 8

Volatility on OATs weighed on EUR



Source: Bloomberg, ANIMA Research

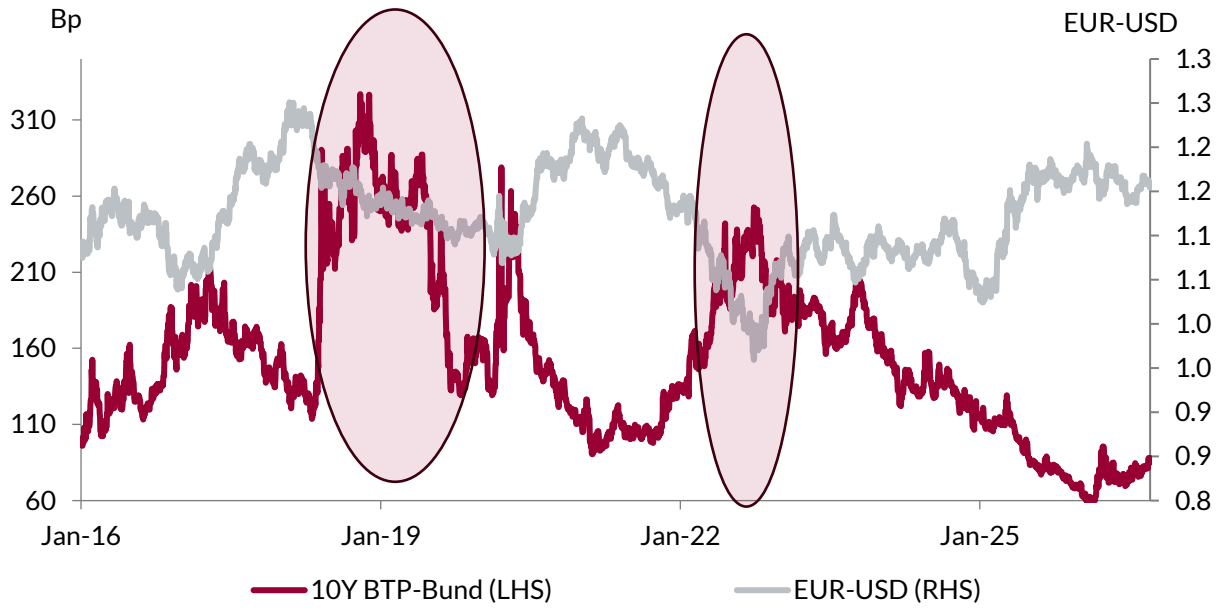
2) EUR could come under pressure well ahead of the French elections

Last but not least, next year key general elections will take place in nine EU countries. The most important one for EUR performance will be the presidential elections in France. Looking at the episode of the French presidential elections in 2017, the EUR-USD went from 1.12 to 1.04 in Q4 2016, when the OAT-Bund spread started widening and only came back to trade above 1.10 in mid-May 2017 when it became clear that Le Pen had lost the presidential elections. Moreover, in 2025, during the most acute phases of the political crisis in France the EUR came temporarily under pressure (Figure 8). We expect the EUR to come under pressure this time as well, although later in terms of timing and more moderately compared to the 2017 episode in terms of size, as markets' concerns should be more focused on French fiscal credibility rather than a French exit from the eurozone, as was the case in 2017.

Italy will also hold general elections between April and October 2027. Historical evidence suggests that there could be a negative impact on the EUR (Figure 9), but we think it will be fairly moderate, given that Italy's fiscal credibility will not be called into question and markets' concerns about populist measures will be very contained after the Meloni government experience.

Figure 9

EUR suffered in the past also on BTP volatility



Source: Bloomberg, ANIMA Research

Bottom-line

Against this backdrop, **strategically, we switch to a NEGATIVE position on DXY (from NEUTRAL), while we remain strategically NEUTRAL on EUR-USD,** as we believe that, in the medium-term, the negative factors for the EUR and the USD may offset each other.

Yen: The trend is turning

We believe that the trend has turned from negative to positive for the yen, for the following reasons:

1) The Yen is sizably undervalued according to our BEER model

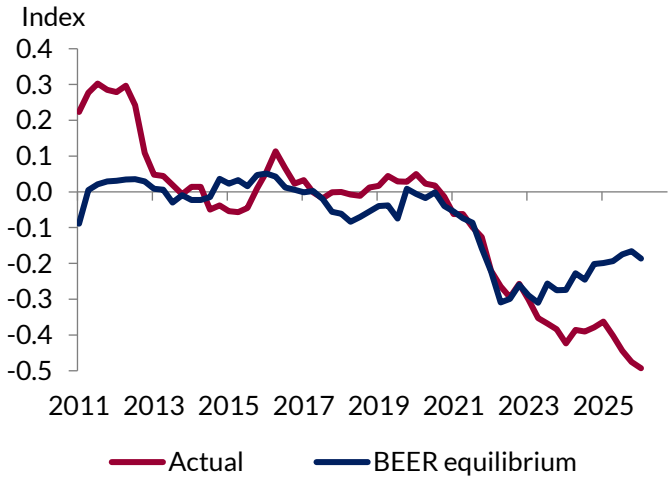
The ANIMA BEER model shows that since mid-2023, the yen real exchange rate has been undervalued, with its undervaluation becoming more and more pronounced each quarter (Figure 10). At the moment, our model indicates that the yen real exchange rate is undervalued by 20-25%. While until now cyclical and structural factors were weighing on the yen, preventing its return towards its long-term equilibrium, we think that these factors have gradually started to fade or change, leaving room for the yen to change course and revert towards its long-term equilibrium.

2) Political will has started to reverse the negative yen trend

Political will to prop up the yen has surely been one of the factors contributing to the change in trend. Figure 11 shows that the decline in international reserves to carry out yen-supporting interventions, both in April/May and July/August, was very high historically. Moreover, US Treasury Secretary Bessent has been recently very vocal in pushing the BoJ to adopt a tighter monetary policy and even went as far as warning traders not bet against the yen. While we believe that, had these moves remained without a policy follow-up, they would have offered only temporary support to the yen, the fact that the BoJ has adopted a more hawkish stance helped the yen reverse the bearish trend for good.

Figure 10

Yen greatly undervalued vs. ANIMA BEER equilibrium



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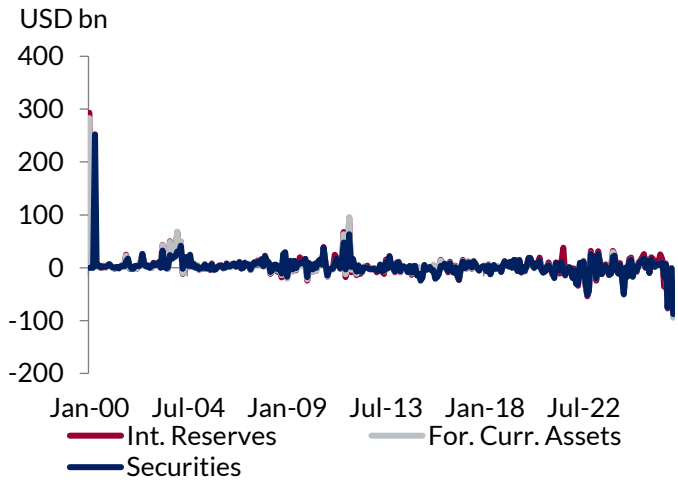
Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 11

Outsized interventions in favor of the yen



Source: Bloomberg, ANIMA Research

3) The BoJ is turning more hawkish

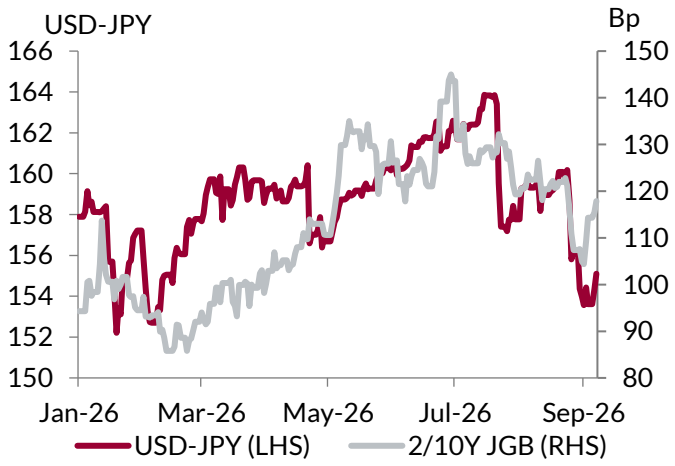
We believe that the more hawkish rhetoric adopted by the BoJ was a decisive factor that changed for good the weakening yen trend. While, following the intervention in July/August, USD-JPY started rising again towards 160, since the start of September, when the BoJ turned more hawkish, the rally in the yen has proceeded more decisively, with the yen correlating again with real yields and the shape of the JGB curve (flatter curve, stronger yen, Figure 12). While the September BoJ meeting was interpreted by markets as more dovish than expected (Toichiro Asada and Ayano Sato, the two members who were picked by prime Minister Takaichi, dissented on the hike and Ueda gave contrasting messages at the press conference), weighing on the yen, we think that this might be a temporary setback in the currency, as the political willingness is clearly there to defend the yen (Ueda said that the BoJ has entered a new stage of policy-making) and the commitment of the BoJ is still not to be perceived too much behind the curve.

4) The fiscal outlook is not weak enough to be a threat to the currency

Japanese ministries submitted a record JPY 143.1tn in spending requests for the fiscal year starting April 2027, up sharply from JPY 122tn in the prior year's requests and exceeding the combined size of the current initial and supplementary budgets. That said, the higher number for FY 2027 may already include the supplementary budget and in that case the two numbers would be roughly in line. On top of that, Prime Minister Takaichi said that the government is considering a new defence spending target of 3.5% of GDP over 10 years vs. the current 2% of GDP.
That said, we think that, provided the BoJ maintains a hawkish stance, markets should not be too much concerned about the fiscal outlook, as Japan compares favourably to the rest of the developed economies in terms of debt metrics (excluding the debt/GDP ratio). Meanwhile, the new approach of the government, based on a new multi-year financial framework, may shift the focus towards a longer-term approach to fiscal discipline.

Figure 12

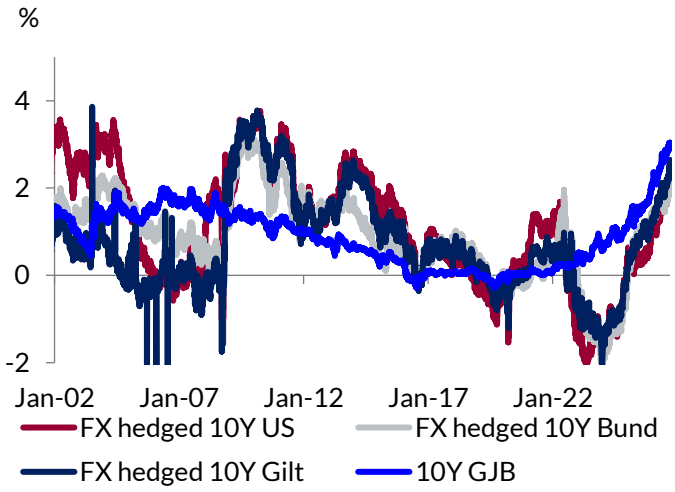
Since the start of September the yen appreciated and the JGB curve flattened



Source: Bloomberg, ANIMA Research

Figure 13

JGBs are more attractive than hedged foreign bonds



Source: Bloomberg, ANIMA Research

5) Probability of repatriation flows is rising

While so far only banks have been active in selling foreign bonds, we think that more Japanese investors could start reducing their exposure to foreign bonds and increase their exposure to domestic bonds, for the following reasons:

1) Investors in foreign bonds with unhedged positions would not want to be exposed to FX losses if the yen continues to appreciate.

2) For a Japanese investor, it is more convenient to hold a domestic bond rather than a foreign bond after hedging currency exposure (Figure 13). While this has been the case for some time, JGBs have not been appealing so far for Japanese investors due to their volatility and expectations of further sell-offs, especially at

the long-end of the curve. With a more responsive BoJ, JGBs could become more appealing both for domestic and for foreign investors.

3) Political will. Finance Minister Katayama said in July that Japan wanted to encourage the Government Pension Investment Fund (GPIF) to invest more domestically, including in JGBs. GPIF decides its asset allocation every 5 years and, at the moment, its strategic allocation (established in 2025) is 25% in foreign bonds, 25% in domestic bonds, 25% in foreign equity, and 25% in domestic equity. Compared to this strategic allocation, it has the flexibility of over/underweighting each asset class by around 5%. Taking into account that the current allocation to foreign bonds amounts to around JPY 72tn and that to domestic bonds to around JPY 68tn, we estimate that under current allocation rules the GPIF could sell JPY 3.5tn of foreign bonds and buy the same amount of domestic bonds. While this would not be a game changer, GPIF could decide to revise its allocation before 2030 and invest a more substantial amount in JGBs, which would lead to a rally in JGBs and the yen, considering that part of GPIF's foreign bond holdings is unhedged.

6) Hedging FX exposure by Japanese investors could exacerbate the trend

While some Japanese investors may decide to keep their exposure to foreign bonds, they may decide to hedge it, especially if they believe that the trend has turned for the better on the Japanese yen. Putting in place hedges on existing exposure to foreign assets would contribute to support further the yen. This is particularly relevant for life insurers and pension funds. For insurers their hedging ratio is around 45% an historical low, while pension funds invest mainly on an unhedged basis.

Bottom-line

Against this backdrop, **we would strategically position SHORT USD-JPY.**

Appendix: ANIMA BEER model

The ANIMA BEER (Behavioural Equilibrium Exchange Rate) model is a new quantitative tool that we employ to monitor exchange-rate levels vis-à-vis an estimated equilibrium driven by fundamental variables. The BEER class of models is a widely accepted framework employed by academics, public policy institutions and banks and its origin is attributed to Clark and MacDonald (1998).

With the BEER, we investigate the relationship between a synthetic indicator of exchange rates (a REER, Real Effective Exchange Rate) and a set of variables that determine its behaviour. We consider ten different advanced economies (United States, the euro area, Japan, the United Kingdom, Australia, Canada, New Zealand, Norway, Sweden and Switzerland) for which we estimate a common long-run relationship between the REER and its fundamentals. At any moment in time, temporary shocks may generate short-run deviations from equilibrium, which the model captures through country-specific dynamics. Since we focus on real exchange rates, we first use relative CPIs across countries to obtain real bilateral exchange rates. We then aggregate these bilateral rates into a synthetic, trade-weighted indicator of real exchange rates. Ina nutshell, the REER summarizes several real bilateral exchange rates, weighting them according to the relative trade between country pairs.

We consider three economic variables that may affect our synthetic REER. The variables are expressed relative to the same trade-weighted foreign basket.

1) A productivity variable. We choose labour. Higher domestic productivity relative to the foreign basket should be associated with a stronger equilibrium REER.
2) A trade-related variable: terms of trade. This is the ratio between export prices and import prices. An improvement in relative terms of trade should be associated with a stronger equilibrium REER.
3) The differential between domestic nominal five-year rates and the trade-weighted foreign rate. We choose five-year rates because we believe that they are less directly dominated by short-term monetary-policy actions than shorter-term rates. Again, higher relative five-year rate should be associated with a stronger equilibrium REER.

Labour productivity and terms of trade are expressed in logarithms and transformed into chain-linked relative indices, while the five-year rate differential is expressed in levels and is not chain-linked. The estimated coefficients are all positive, statistically significant and consistent with these expected economic signs.

We believe that fundamental relationships are shared by several economies. However, as several studies point out, country heterogeneity may strongly influence and potentially bias the results. We therefore select ten advanced economies with floating exchange rates, albeit to different degrees, and with broadly similar economic and institutional characteristics (United States, the euro area, Japan, the United Kingdom, Australia, Canada, New Zealand, Norway, Sweden and Switzerland). The sample includes both commodity importers and commodity exporters. This represents a simplification, as terms-of-trade movements may affect the two groups differently. However, according to our robustness checks, distinguishing between the two groups does not materially change the main results or the message conveyed by the model.

Our model is estimated through a common-slope Panel DOLS (Dynamic Ordinary Least Squares) using a sequential procedure inspired by Mark and Sul (*Cointegration Vector Estimation by Panel DOLS and Long-Run Money Demand, 2003*). The method estimates a homogeneous cointegrating vector while allowing for country fixed effects, time effects and country-specific short-run dynamics.

The equilibrium REER is obtained from the estimated contribution of the three fundamentals and the recovered country fixed effect. The common time effect is not part of the equilibrium. Indeed, we leverage the model to track the developments of an equilibrium based on country-specific fundamentals.

Model equation

$$y_{i,t} = \underbrace{\alpha_i}_{\substack{country\\ fixed\\ effect}} + \underbrace{\delta_t}_{\substack{time\\ effect}} + \underbrace{\underline{\beta}' \begin{pmatrix} x^{LP} \\ x^{TOT} \\ x^{R5T} \end{pmatrix}_{i,t}}_{\substack{long-run\\ relationship}} + \underbrace{\sum_{k=-1}^{2} \underline{\Phi}'_{i,s} \Delta \begin{pmatrix} x^{LP} \\ x^{TOT} \\ x^{R5Y} \end{pmatrix}_{i,t-k}}_{\substack{short-run\\ relationship}} + u_{i,t}$$

In the equation above, i identifies the country and t identifies the quarter, $\underline{\beta}$ is the common vector of long-run coefficients of the long-run relationship, $\underline{\Phi}$ is the vector of coefficients for the country-specific short-run dynamics of the model, and u is the error term. Since the parameter k takes values between -1 and 2, we take the contemporaneous first differences of the explanatory variables, one lead and two lags. These terms are included to control for short-run dynamics and potential endogeneity when estimating the common long-run coefficients.

We compare the results of our model with the ones from one of the most recent ECB publications on the topic by Ca' Zorzi et Al. (2020), and the Deutsch Bank DBEER model. Both models return similar results to our, sharing a common interpretative framework, albeit adopting different estimation procedures.

ANIMA INVESTMENT RESEARCH

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