

## FX: The dollar deflates

Given the US dependency on the capital markets for financing, the Fed looks set to be at the forefront of the monetary response to the Covid-19 crisis. The end of US 'exceptionalism' in terms of growth and interest rates means that we should now be looking at a temporary 5-10% correction in the dollar. We revise our 2Q20 EUR/USD forecast up to 1.15



### Trouble sticks to the formerly Teflon dollar

2018 to 2019 was characterised by the tax stimulus-powered US economy and President Trump's trade war. The combination of strong domestic US growth set against a slow-down in more open overseas economies created the investment theme of 'US exceptionalism' and triggered a 10% rally in the trade-weighted dollar.

Covid-19, of course, respects no borders and now represents a 'levelling' force in the global economy. US growth and interest rates are therefore converging on the low levels seen overseas and beg the question whether the dollar should still be so strong?

---

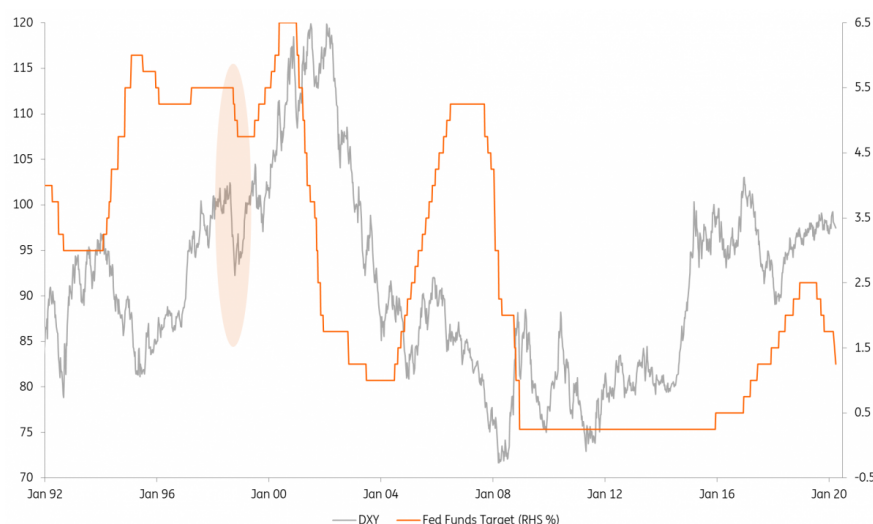
*If we are to see a EUR/USD correction this year, it should prove*

*temporary*

We see (some) parallels here to the 1998 period. Following broad-based dollar strength and US productivity growth from 1995 onwards, US markets received a shock in 1998. The Asian financial crisis spilled over to a Russian sovereign default that year, triggering a collapse in the US hedge fund, LTCM. In response to threats to the financial system, the Fed cut rates 25bp in September, October and November triggering a 10% correction in the dollar.

Arguably dollar fundamentals were a lot stronger then, given the budget surplus and a slim current account deficit, than they are now and explained the quick recovery which saw USD push back to new highs in 2000. Parallels today also extend to the poor European investment climate that existed in 1999-2001. Europe does not look a very attractive investment destination right now meaning that if we are to see a EUR/USD correction this year, it should prove temporary.

### Emergency Fed cuts should start to soften the dollar



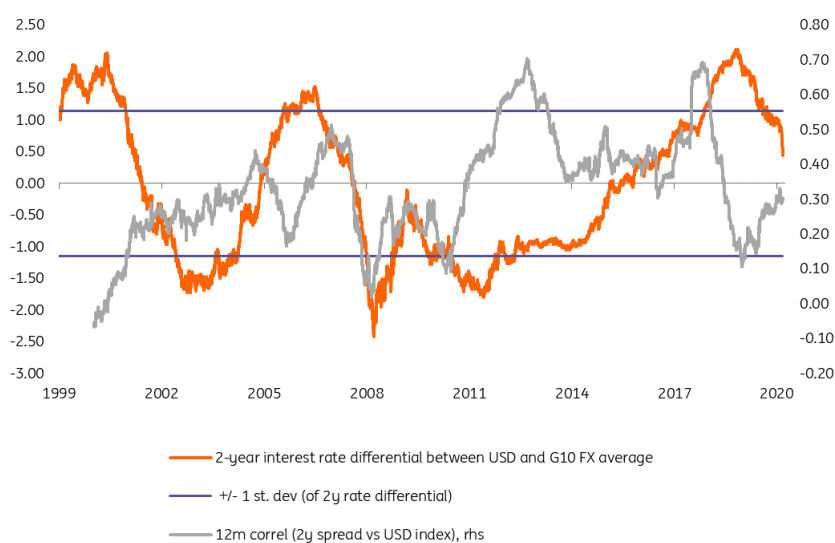
Source: Bloomberg, ING

### The dollar's soft centre

The US economy's dependency on the securities markets for financing means that the Fed will be at the forefront of the monetary response to Covid-19. This is important since no longer are US short-end rates anchored by a Fed needing 'material' changes to move. Instead of bullish flattening in the US yield curve as markets price a late-cycle slow-down, the bullish steepening represents reflationary Fed policy – i.e. a Fed response underway. A weaker dollar is a typical part of the Fed's reflationary tool-kit and is especially the case in this US election year.

Our point here is that the Fed looks set to bow to the increased financial market and later real sector pressure (we expect another 50bp of Fed easing) and US rates will continue to converge on those of trading partners. The narrower interest differentials become, the greater their correlation with FX markets in our opinion. We could easily see US two-year spreads against EUR and JPY narrowing by another 50bp, for example, making it a little easier to FX hedge US bond portfolios.

## As dollar rate differentials return to more normal levels, the correlation between differentials and dollar pricing increases



Source: Bloomberg, ING

### New EUR/USD profile

Now incorporating a 100bp Fed easing cycle and very little room to manoeuvre from the ECB, we look for EUR/USD to correct higher over the next three to four months. This move could carry EUR/USD to the 1.15 area. We then tentatively pencil in a correction back to 1.10 by year-end and throughout 2021.

The lower profile over the longer term incorporates the views that:

1. the Fed takes back the 100bp easing cycle in its entirety through 2021 and
2. US presidential elections do not demand a significant risk premium of the dollar.

Clearly this scenario can be challenged by:

1. a larger US slow-down that keeps the Fed policy rate lower for longer and
2. potentially weaker growth, giving Bernie Sanders a better shot at the White House. But that is not our baseline.

Away from the dollar correction, we expect pro-cyclical and EM high yield currencies to underperform the defensive JPY and EUR through March. We expect asset market volatility to remain high over this period and discourage investors from carry trade strategies. Once equity markets settle down, however, we suspect investors will be positively re-assessing high yield FX markets given that risk-free interest rates will have fallen below 1%.

## Our new EUR/USD forecast profile



Source: Bloomberg, ING

### Author

#### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

### Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.