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FX

## FX: Dollar struggles to shake off the negatives

The dollar's bounce has been lacklustre, unlike US equity and bond markets, which have recovered from the April lows. Preventing more of a recovery in the dollar seems to be uncertainty around US policy and an expectation that FX hedge ratios on US assets will have to be raised



The dollar's rebound has been underwhelming

### Fact versus fiction

The theme of de-dollarisation is rife in global financial markets. We think the transition away from the unipolar dollar world will be a long one, but April's dislocation in US asset markets has clearly brought this theme into sharp focus. We've written extensively about that [here](#).

And it is important to separate the cyclical from the structural here. A 13% decline in the share of USD holdings amongst FX reserve managers since 2000 should not be confused with the cyclical adjustment of asset managers rotating out of US assets in February and March. The only data we have here shows that foreigners did indeed buy a lot of eurozone equities in February, while they also slowed their purchases of US equities in the same month.

We intend to keep a close watch of Balance of Payments data over the coming months to see if the portfolio flow data does corroborate reports of foreigners leaving US asset markets.

What is virtually impossible to tell, however, is the amount of dollar selling underway relating

to the adjustment of dollar hedges. Here, investment committees at buy-side firms may just take the view that in the shadow of the Mar-a-Lago accord – a series of potential deals to get the dollar lower – it may be worth increasing the hedge ratios on US investments.

Some studies suggest the buy-side in aggregate has FX hedge ratios in the 30-40% range for US assets, though that can be much higher for certain communities, such as life insurers. Helping the buy-side to reach those decisions would be Federal Reserve policy, where a more dovish central bank and lower USD swap rates would lower dollar hedging costs. This may well be a theme for late summer.

Before then, we cautiously expect EUR/USD to trade in a 1.12-1.15 range. Limiting the upside will be the dovish ECB and a soft eurozone growth story. And we think EUR/USD is already trading at stretched levels relative to short-term rate differentials. Yet at the same time, the medium-term fundamentals are starting to improve with lower oil prices.

If any trading nation with the US were to conclude a deal which included the exchange rate, we think the dollar could fall another 5% across the board. As such, we are not ruling out a move to 1.20 this year – but it's not our baseline.

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