Dovish Fed favours LatAm FX

The Federal Reserve has taken both rate hikes off the 2019 projections and promised to reduce the pace of quantiative tightening. Here's what that means for FX markets

Source: iStock

USD: The Fed is done

The Fed delivered a meaningful dovish surprise yesterday, taking both hikes off the 2019 projections, and reducing the pace of quantitative tightening from May (from $30 billion to $15 billion per month) and ending this September. Like the European Central Bank, the Fed surprised on the dovish side but, unlike the ECB, the downward revision to growth projections was limited. This should reduce market concerns on the global economic outlook and put more emphasis on the Fed's (risk supportive) loose monetary stance. With the Fed unlikely to hike in this cycle (see FOMC Review) and the US twin deficit in place, the US dollar now lacks catalysts for another persistent push higher. LatAm FX is, in our view, the best positioned to benefit given the mix of (a) dovish Fed (b) still solid US growth (c) recovering oil prices (to which the region is the most sensitive among EM FX). The Mexican peso will remain an outperformer, helped by the above factors as well as the attractive local bond market, as Banxico approaches the start of its easing cycle.

EUR: Only very slow grind in EUR/USD higher over the course of this year

EUR/USD rallied in response to the dovish Fed, but the pair was held by the 1.1450 resistance. While EUR/USD re-testing the 1.10 level seems unlikely now (as we no longer expect the Fed to hike) any move in EUR/USD higher should be rather slow, as the initial Fed-induced adjustment is behind us while the ECB is unlikely to turn hawkish. Our end-2019 forecast of EUR/USD 1.20 remains valid and predicated on the US twin deficit slowly taking away USD support. In Switzerland, the central bank is expected to remain on hold, with the key EUR/CHF driver currently being Brexit uncertainty and EUR/CHF inversely trading to EUR/GBP.

GBP: More divisions in place

We expect the Bank of England to remain on hold. The central bank made it clear that, as things stand, growth will be slow for much of the year. Coupled with Brexit uncertainty, the BoE will remain on the sidelines for the time being. Prime Minister Theresa May delivered a rather aggressive speech yesterday, attempting to push MPs to back her deal (in the likely third meaningful vote next week). This, in effect, further increased the division in parliament. We expect GBP to struggle ahead of next week's vote as (a) the outcome remains highly uncertain (b) the UK is getting closer to the cliff edge.

NOK: Hike but not a dovish one

We expect the Norges Bank to hike today, in line with its forecast. Inflation remains high, domestic data is solid, oil prices are stronger and the Norwegian krone is weaker vs the NB forecast. We expect interest rate forecasts to remain unchanged, pointing to another hike in 2H19. We don't look for a dovish hike (given the more mechanical approach of the NB), meaning that NOK should retain support.