Emerging market FX walking a fine line

The US dollar regime shift has implications for debt-centric emerging markets

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USD: Regime change underway

Today we have published a new report entitled: Dollar Regime Change: The Prequel looking at the divergence in US yields and the dollar. Our key points are:

- This year's rise in Treasury yields looks to have been driven more by the term premium and embodying US fiscal risks, thus a weaker dollar is the cost of financing larger deficits
- The recent sharp adjustment in correlations happens rarely and on average has seen USD/JPY decline 6% over a subsequent three-month period
- We're happy with our year-end forecasts for EUR/USD and USD/JPY at 1.30 and 100 respectively
- We think abrupt moves in 10-year Treasury yields (e.g. a two standard deviation move of 24bp in a week) are more important to emerging market portfolio flows than absolute yield levels per se. Debt-centric EM FX would be more vulnerable were this to occur, e.g. CEEMEA and Latam, rather than Asia. Those countries vulnerable to a sudden stop in portfolio flows remain Turkey, Argentina and Ukraine. In the near term, we cannot see much to turn this dollar bear trend around (FOMC minutes next Wed?). DXY to 87.25.

EUR: Carried along for the ride

The Euro looks to be well-placed to benefit from the loss of confidence in the dollar. Only the Euro and Japanese yen offer the liquidity to make them serious alternative investment destinations for both public and private investors. No doubt we have not heard the last of ECB criticism of US weak dollar rhetoric – an issue that may again re-appear at the G20 in mid-March. While US authorities may pay lip-service to a stronger dollar, we all know that America First equates to a weak dollar policy. In any case, the EUR trade-weighted index strength has not been too abrupt. We suspect EUR/USD near-term wants to test a big trendline at 1.2670.

GBP: Focusing on the positives

GBP/USD is enjoying the weak dollar environment and is taking a glass half-full attitude to Brexit (news today on the UK position on financial services). Cable should be supported at 1.40.

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