FX: A dollar decline is delayed, not deterred

The dollar is an expensive sell, especially after the recent rise in US treasury yields. In the near term, we could see it hold on to February's gains, but our call for larger Fed rate cuts than market pricing means we still favour a bearish USD profile for the remainder of the year. We target 1.14 in EUR/USD and remain positive on commodity currencies

We think that sticky inflation on both sides of the Atlantic is likely to keep upward pressure on market yields over the coming month

The FX market continues to be an extension of market expectations on Fed policy. The latest data on US jobs and inflation led investors to price out cuts before June and to reduce the anticipated easing package to 75-80bp. The month of February has seen a 50bp bump in the 2-year USD swap rate, which is trading around 4.55%, the highest since November.

So, the dollar has become even more expensive to sell, and dollar bears are now on the hunt for more conclusive evidence on US disinflation/hard landing. That evidence is currently pointing in the opposite direction, at least when it comes to hard data, and this looks unlikely to change abruptly in the near term. This means the dollar can hang around these strong levels for a bit longer, leaving the broader FX market without a clear sense of direction.

Our medium-term FX views remain, however, broadly unchanged, and centred around a dollar depreciation. We think markets are now underestimating the size of 2024 Fed cuts by around 50bp (our economists forecast 125bp). The pace of the US dollar decline may be only gradual in the next couple of months but should accelerate into the first Fed cut in June and beyond.

We expect to see EUR/USD move to 1.14 by year-end, as a moderately-sized European Central Bank easing package (75bp versus 100bp priced in) should also favour a largely Fed-led EUR:USD front-end rate convergence. In the G10 space, we continue to see good upside potential for commodity currencies, in particular, the undervalued Norwegian krone, Aussie dollar and New Zealand dollar.

In emerging markets, the Chinese yuan should continue to be driven by China-specific factors until US rates move decisively lower and allow USD/CNY to decline sustainably. The upcoming Two Sessions is a key risk event for the yuan and China-sensitive currencies. In Latam, the Mexican peso and Brazilian real may well prove resilient despite ongoing rate-cutting cycles; while in the CEE region, we expect the paths of the Polish zloty (strong) and Hungarian forint (weak) to keep diverging.

The key risks to our bearish dollar view are a potential USD positive/EM negative re-election of Donald Trump, or – from a purely macro perspective – prolonged resilience in US inflation and consequent further delay in Fed easing.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer