

Article | 12 May 2023

FX

FX: A stronger case for a weaker dollar

Fresh turmoil in the US banking sector is raising the chances of dollar underperformance in the latter part of the year, when we expect the Fed to cut rates by 100bp and US-eurozone divergence to drive EUR/USD to a 1.20 peak. However, some risks – including the US debt ceiling stalemate – can keep the dollar afloat in the short term



The dollar's decline looks to be part of an orderly adjustment cycle as the Fed prepares to cut rates

A month ago, we stated that the key challenge in the currency market was timing the dollar sell-off. A few weeks of stabilisation in the dollar suggest this is, indeed, still the case. And, while the Federal Reserve presumably reaching its peak and US inflation continuing its descent hardly came as a surprise, the last month provided – in our opinion – more evidence in support of a bearish dollar case in the second half of the year. The resurgence of stress in the US banking sector recently warned of a more deeply rooted crisis in the regional lenders' system. While the government and Fed are keeping it from becoming a full-fledged financial catastrophe, the ramifications for the whole economy are deepening.

A substantial tightening of credit conditions beyond the Fed rate hikes effect is now pointing at a sharp downturn in the US economy, and we forecast the Fed will respond with 100bp of cuts later this year. On the other side of the Atlantic, the ECB is not in a hurry to give up its hawkish stance, and while we only anticipate one more 25bp hike this year, rate cuts should not be expected until the second half of 2024.

The widening of the US-eurozone and Fed-ECB divergence in the latter part of this year and the start of next year led us to revise our EUR/USD forecast higher: we now expect a peak at 1.20 in 4Q23/1Q24, before a descent to 1.15 toward the back-end of 2024 as the ECB starts easing.

The short-term outlook is admittedly less of a clear-cut bearish story for the dollar. It is important to take positioning into account, and the dollar is markedly oversold against the euro. Incidentally, if US banking stress can hit the dollar via the rate cut channel in the longer run, it can also keep it afloat in the short term by hurting risk sentiment and increasing safe-haven demand. Should the US debt ceiling stalemate result in substantial turbulence in money markets, it can also lead to a dramatic increase in demand for dollars.

From a different perspective, these shorter-term dangers led us to restate our bullish call on the yen, which may also benefit from the Bank of Japan's surprise hawkish tilt this summer. Elsewhere, we now expect GBP/USD to break through 1.30 before the end of the year, although the euro's outperformance over sterling (EUR/GBP to rise to 0.90) remains our base case.

Author

Francesco Pesole

FX Strategist

francesco.pesole@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.

THINK economic and financial analysis

Additional information is available on request. For more information about ING Group, please visit www.ing.com.