FX: Challenging our bearish dollar forecast

Our bearish dollar view for 2021 has been built firstly on the Federal Reserve keeping policy very loose and secondly on the synchronised global recovery providing attractive alternatives outside of the US. Both premises are coming into question. Yet we think it too early to be making wholesale changes to our dollar forecasts

Source: Shutterstock

Confidence in reflationary trends under threat

Reflationary trends across asset classes, such as higher equities, higher commodities, steeper yield curves, and a weaker dollar require two key ingredients. The first is central banks (largely the Fed) keeping policy very loose and ideally driving real interest rates deep into negative territory – this the Fed has done.

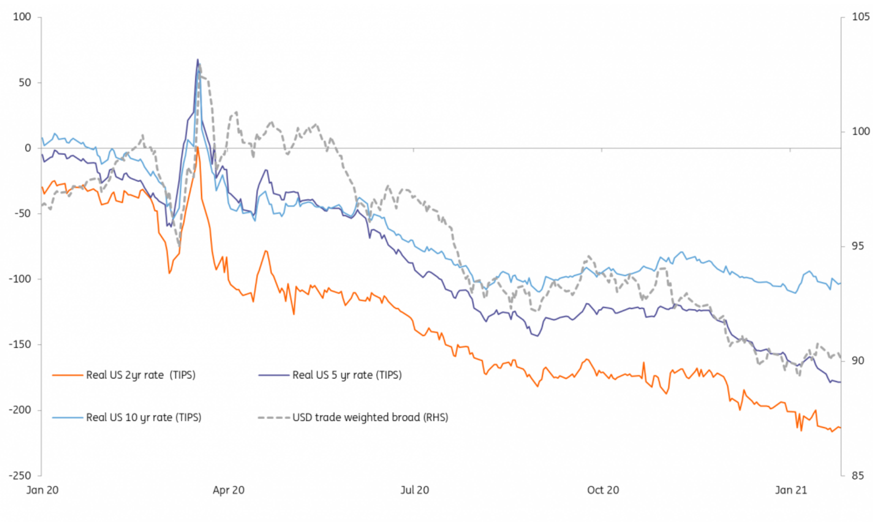
The question now is whether significant US fiscal stimulus and a seemingly successful vaccine rollout in the US prompt the Fed to rein in loose monetary conditions. While Fed tapering expectations may drive longer-term real interest rates higher later this year, shorter-term real interest rates should remain rooted deeply in negative territory. This is because we doubt the Fed will want expectations of rate hikes to rise too quickly, nor inflation expectations to fall back – consistent with its Average Inflation Target policy.

The second ingredient in the secret sauce of reflationary trends is investors buying into recovery stories. Here huge fiscal stimulus and the rollout of vaccines certainly dominated trends through late 2020 – though confidence in a synchronised global recovery is starting to fray around the edges.

Our macro team is still largely holding onto 2Q onward recovery stories – even in Europe. This breakout quarter for growth should prove supportive for global reflationary trends and negative for the dollar. The European Central Bank will not like it, but we still see a case for EUR/USD pressing 1.25 this summer.

We will watch both these trends carefully. Should the Fed surprise by applying the brakes to monetary policy early (driving short-term real interest settings higher) or extended lockdowns in Europe push back the timing of the synchronised global recovery even further – we would have to revise our dollar forecasts higher. But we are not there yet.

Real interest rates have dragged the dollar lower since March



Source: Refinitiv, ING

Upgrading the pound

The dust is beginning to settle on the Brexit deal and the UK is making good progress on its vaccination rollout. Since last spring, we had been running with a flat EUR/GBP forecast through 2021 at around the 0.88/90 area.

Now looks the time to refine that profile. Based on our medium-term fair value estimates, we see EUR/GBP around 7% overvalued at current levels. Of course, there will be setbacks along the way, yet the removal of the Brexit uncertainty and a relatively good chance of reopening the UK economy in 2Q21 should allow EUR/GBP to start slowly making its way towards the 0.82 area by end of 2022.

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