The focus on local FX champions

The currency market is no longer primarily focused on Federal Reserve rate expectations. While we expect the Fed to finally cut rates in September as we begin to see softer data, domestic political and central bank stories should determine which currencies will benefit from a weaker dollar

The half-time review

For most of the past year or so, investors and analysts were mostly focused on guessing the timing and size of the Federal Reserve's cutting cycle, identifying that as the main driver for a broad-based dollar decline. Since the end of May, political factors have taken a central role, making the link between a more dovish Fed pricing and a weaker dollar less stable.

We think that FX investors are having to take a lot more into account. And it's not just about politics in the US and the eurozone. It's also about the underlying central bank and economic fundamental stories that can make or break FX rallies in the many risk-on/dollar-off windows we expect to see this summer.

1 Second-half prediction: The strugglers

We believe the euro, sterling, the Canadian dollar and the Swiss franc will struggle more than others in the G10 to outperform in the next couple of months. We estimate that those are the only four currencies which cannot count on an economic fundamental-based undervaluation against the US dollar. More specifically, the euro may well remain trapped around 1.08 by the French political gridlock and related fiscal concerns despite a relatively market-friendly outcome of the parliamentary election. Sterling may take a hit from the start of the Bank of England's cutting cycle in August, while the Canadian dollar and the Swiss franc could be dampened by ongoing domestic easing and soft data.

Second-half prediction: Unlocking potential

In the undervalued camp, we think central bank policy will be key to unlocking upside potential. The Australian dollar and the Norwegian krone look to be in a good position to lead the pack, as the Reserve Bank of Australia might hike, and Norges Bank should stay hawkish. The New Zealand dollar also continues to look attractive to some, despite the country's central bank's latest dovish tilt, while the Swedish krona has more limited room for appreciation given the Riksbank's easing plans. The yen remains in a vulnerable position as investors continue to test new intervention levels (we believe these are close to 165.0). However, we narrowly favour a Bank of Japan hike later this month, which can join forces with a dovish Fed repricing to start driving USD/JPY lower.

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