FX: Compressed Fed exit sequence prompts dollar forecast upgrade

Having been dollar bears since April 2020, this month we feel compelled to raise our forecast dollar profile on what appears to be the start of a more conventional tightening cycle from the Federal Reserve. We are cutting our year-end 2021 EUR/USD forecast to 1.23 from 1.28. And we now expect EUR/USD to end 2022 at 1.15

Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System

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Average Inflation Targeting in abeyance

Regular readers of our FX research will know that we had felt there was a window for EUR/USD to stage a sizable rally through 2H21 and into early 2022. That window was to be provided by a Fed keeping ultra-dovish policy and negative real rates later into a cycle than normal and allowing European and global recovery cycles to drive EUR/USD higher.

What has changed is that the Fed looks less committed to Average Inflation Targeting and more towards a conventional lift-off in rates which could come as early as autumn 2022. This assumes the Fed starts tapering shortly after the August Jackson Hole gathering– a tapering process that could last until spring/summer '22.

On the assumption that the Fed starts formally tightening in 3Q22, it would be no surprise to see a bearish flattening of the US yield curve – preparing for the Fed to apply the monetary brakes – from 2Q22 onwards. That is when we would expect the dollar to embark on a broad rally.

EUR/USD upside now 1.23 not 1.28

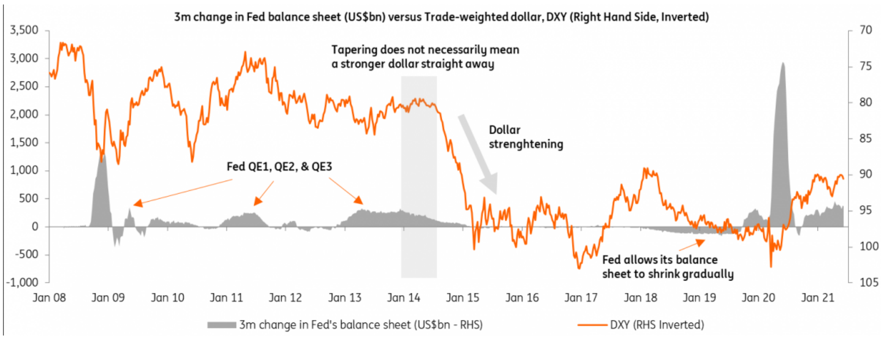
Before the broad dollar rally we expect in 2Q22, the Fed environment should allow local FX stories to play out. Tapering itself does not mean that the dollar has to rally across the board and a large part of the broad dollar rally late in 2014 (a year in which the Fed tapered) was driven by the ECB preparing markets for its quantitative easing policy – enacted in early 2015. That kind of policy divergence will not be present this time around.

That is why we still think there is scope for EUR/USD to rally into year-end – typically a seasonally weak period for the dollar – but that the upside is more likely to be limited to the 1.23 area than the 1.28 area we had expected previously. Driving EUR/USD higher should be hard eurozone data delivering on the bullish survey data, the pick-up in eurozone inflation relative to the US, and a continued rotation into European equity markets.

With quite a lot now priced for the Fed, we suspect that risk assets can continue to hold their ground this year and that in general the commodity complex and those emerging market currencies backed by front-loaded tightening cycles can continue to make gains against the dollar. Expect continued interest in the euro, Swiss franc, or Japanese yen-funded carry trades.

Into 2022, however, we see the dollar turning higher more broadly, with EUR/USD and USD/JPY ending 2022 near 1.15 and 1.20, respectively. And as 2022 evolves, the impending withdrawal of liquidity by the Fed will decrease the margin of error allowed for risk assets.

Fed tapering need not mean a stronger dollar straight away



Source: Federal Reserve, ING

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