

FX Daily: Central banks mobilise, dollar weakens

Both the Federal Reserve and the Bank of Japan say they are 'closely monitoring' developments on the coronavirus, and the implications for the economic outlook. This suggests the dollar is heading lower



📉 USD: The question is when and by how much the Fed eases

The impact of the coronavirus on financial markets has prompted central banks to mobilise. Both the Federal Reserve and the Bank of Japan have issued statements that they are 'closely monitoring' developments and their implications for the economic outlook. Whilst this is not the kind of financial crisis that triggered emergency Fed easing cycles in 1998 and 2008, the recent sharp widening in credit spreads (e.g. US BBB-Treasury spreads 30 basis points wider last week) and equity losses mean the Fed is ready to act. In addition to providing extra liquidity (e.g. BoJ undertook a large JGB repo today), the focus will now be on the Fed's easing playbook. From least to most aggressive we see:

1. FOMC Chairman Jerome Powell early this week (probably today or at hastily scheduled testimony in Congress) signalling that the Fed is ready to move at its 18 March meeting
2. A Fed rate cut today, where the Fed ignores criticism over a panicked response and favours early action or

3. Some kind of co-ordinated rate cut. (Eight central banks took part in co-ordinated easing in October 2008). ECB reluctance to participate may see central banks stick to individual responses on their own cycles, meaning the focus is very much on the Fed. A 50 basis point cut now seems to be priced for the 18 March meeting, and any less than that will disappoint equities.

For the dollar, signs now that the Fed is ready to move – and bullish steepening, not flattening of the US Treasury curve – look a dollar negative. In 1998, the 75 basis point easing cycle from the Fed saw a 15% correction in \$/Europe, before \$/Europe returned to a new high a year later. A smaller version of that episode may unfold over coming months. The 99.54 DXY high seen on 20 February could be very significant and a correction to 95 (3% lower) looks the direction of travel.

↑ EUR: ECB will be reluctant to act early

The European Central Bank reaction function under new President Christine Lagarde is still to be evidenced, but our team suspects the ECB will be unwilling to deliver an emergency response. (Next ECB meeting is 12 March). Of course Europe will be hit heavily by the crisis, e.g. the [collapse in China manufacturing PMI](#) bodes ill for European supply chains, but in the FX space, aggressive Fed easing may now start to take its toll on the dollar – even against the unattractive euro. [On Friday](#), we were thinking 1.11/12 could be the best levels for EUR/USD, but expectations over a front-loaded 75bp Fed easing cycle could push EUR/USD even higher.

↓ GBP: Trade talks start today

The Bank of England may now be a little more minded to ease policy and combined with the start of difficult trade negotiations, EUR/GBP could embark on move to 0.88/89.

↑ JPY: Risk assets will stay fragile, despite Fed easing.

Fed easing will provide some temporary support, but it looks like it will be a tough few months for risk assets. We see a 105 scenario playing out in USD/JPY.

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