FX Daily: Dollar hedging costs fall to 2016 lows

Temporary factors are keeping the dollar strong but with dollar hedging costs crumbling, we don't think this will last

USD: Temporary factors keeping $ strong, but $ hedging costs tumbling

The ING research team yesterday released our assessment of what Covid-19 means for the world economy and financial markets. Within the pack, we included our take that the dollar would not be holding onto current gains. We forecast EUR/USD and USD/JPY at 1.20 and 100 at year-end. In addition to temporary factors such as money market dislocation and massive emerging market portfolio outflows fading, what also should weigh on the dollar is the fact that dollar hedging costs are crumbling. With US rate convergence on the rest of the world and now dollar funding cheap through the euro and yen cross currency basis swap market, 3m annualised dollar hedging costs against the EUR and JPY have tumbled to just 1.1% - the lowest since the first half of

2016. That should see dollar hedge ratios increase, when market conditions settle. For today, the highlight will be the US non-farm payrolls figure for March. The 12th of the month is the cut-off period for the survey, meaning that the number will not contain the true fallout of the Covid-19 shock. Also expect further gyrations in oil today. The key players now are the US shale producers. If they are willing to participate in OPEC+ cuts then the crude rally is sustainable. If not, crude sinks back to the lows. It is hard to pin down what is driving dollar strength in the very short term, but we prefer fading the move. DXY may stall at 100.50/101.00.

EUR: FX reserve re-balancing may be weighing

One theme (other than eurozone politics) for EUR/USD weakness is rebalancing by FX reserve managers. Federal Reserve data showed that central bank holdings of Treasuries & Agencies fell $17 billion in the week to Wednesday, probably due to FX intervention from emerging market nations. These reserve managers will then sell EUR/USD to restore the dollar share in FX reserves back to the 60% benchmark. EUR/USD could test 1.0770 today. However, we think theses are good levels to hedge dollars.

GBP: 0.8750 looks important for EUR/GBP

Sterling is taking advantage of the euro's malaise. 0.8750 is big technical level on this cross.

EM: The right and wrong side of the tracks

According to the IIF, March saw a record $83 billion of emerging market portfolio outflows in March. That's huge. While all EM currencies have been hit hard during this crisis, the shape of EM sovereign balance sheets will determine how quickly EM currencies bounce back or whether looming debt crises will prompt fresh FX lows. For example, there is much debate now on whether South Africa needs an IMF programme. We see USD/ZAR going to 20. Downgrade risks also haunt Mexico, as well as twin deficits being a challenge for many, including India (we see USD/INR going to 80). Alternatively, those with stronger balance sheets, such as Russia, may see currencies recover more once the dust settles.

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