

FX Daily: Reflation trade returns with conviction

Investors are refusing to hang around for a U-shaped recovery and are putting money to work straight away. The US Treasury curve is steepening and money is flowing back into emerging markets. This is a bearish environment for the dollar



Source: Shutterstock

📌 USD: Market has the reflation bit between its teeth

This has been a huge week for the reflation trade as investors refuse to hang around for a U-shaped recovery and are putting money to work straight away. After all, the point of quantitative easing is to drive investors out along the credit curve. This story has been most evident this week in the 15 basis point steepening in the US 2-10 year curve – reminiscent of the moves seen in March 2009 when confidence finally returned to the market. IIF data also shows the biggest weekly portfolio inflow into Emerging Markets since early February. A return of investors into EM had been one of our [key tenets for our bearish 2H20 view on the dollar](#) – this story now seems to be unfolding. This environment will favour pro-cyclical currencies and favour equity over bond markets (UST 10 yields to 1.00%), suggesting Asian FX (ex JPY) may be due a catch-up if US-China tension can stay contained (as it has this week). This is a bearish environment for the USD and the JPY as we outlined in our [Road to Recovery framework](#). Given that reflationary conviction is rising,

there is a chance the dollar sells off whatever US jobs number we see today. Poor data will be read as the need for Federal Reserve to keep printing, better data as positive for the global recovery story. The decisive breakout in EUR/USD makes the case for DXY to extend to 95.00.

⬆️ EUR: Europe helps not hinders the global reflation trade

Just over a month ago we were concerned that Europe would derail a global recovery story, as it belatedly did in 2010/12. Now, however, the mood has changed dramatically with aggressive fiscal and monetary support and even some progress on financial burden sharing – a story which should grow into the June 18/19 EU summit. The European Central Bank's extension to its Pandemic Emergency Purchase Programme into 2021 certainly suggests fiscal risk premia can be contained for 2020 at least. EUR/USD has come a long way in a [short space of time](#), but it looks as though the reflation trade and the emerging dollar bear trend can sustain the rally. We are also closely watching the options market for signs of [active buying of upside structures](#), which would add another layer of confidence to our view for 1.15/16 and possibly higher if those hoarding dollars are forced to unload.

⬇️ GBP: Weakness mainly against the EUR

EUR/GBP is back to 0.90 and could trade a little higher if confirmed later today that both sides have made little progress in Brexit talks.

⬆️ KRW: Won should play catch-up

Reflation trades favour equities – an asset class normally associated with Asian FX. US-China trade tension has been holding Asian FX back, but if EUR/SEK can trade at 10.38, we would expect USD/KRW to be trading nearer 1150. For those, like us, who feel the reflation trade has legs, then KRW/JPY should be a 9.40 story.

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