

FX: Dollar pauses for thought

Calling the turn in a major dollar bull trend is a dangerous game and despite the recent 3% correction lower we are not brave enough to say that the dollar has peaked. Instead, with a market now underpricing our forecasts for the Fed cycle, and overpricing our views on the ECB cycle, the dollar could make another run at the highs



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Trading partners play catch-up with the Fed

Last month we discussed the perfect storm driving the dollar higher in the form of solid Fed expectations, the sharp adjustment lower in the Chinese renminbi, and sluggish European growth. Since then, some softer US data (largely confidence and housing) has taken around 45bp out of the Fed cycle. At the same time, the renminbi has managed to stabilise too. Perhaps most importantly, expectations of monetary cycles outside of the US have played catch-up with the Fed.

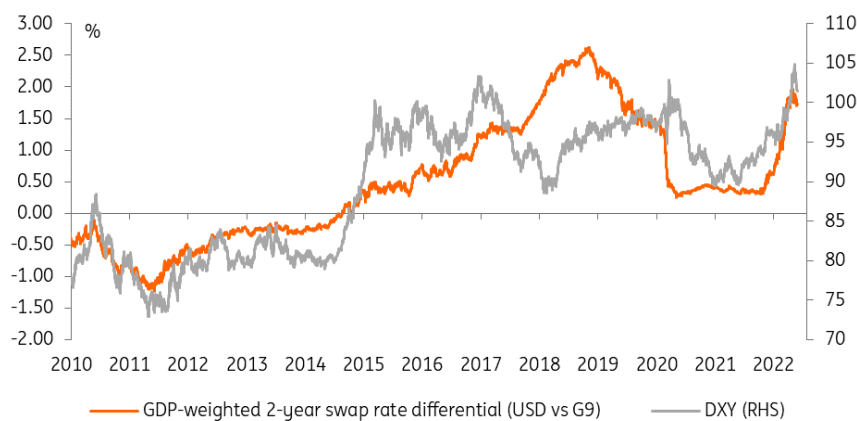
Nowhere is this clearer than in the eurozone, where a concerted assault from the ECB hawks has managed to lift the eurozone money market curve, compress eurozone versus US swap spreads, and bump up EUR/USD. This was probably the ECB's most viable form of verbal intervention to rail against unwelcome euro weakness. It seems strange that the ECB is only now considering the merits of a strong currency given that US and Chinese authorities were considering this a year ago.

And it is not just the ECB that has turned more hawkish. Even the ultra-dovish Swiss National

Bank is sounding more hawkish and detailing the need for a stronger nominal Swiss franc to at least keep the real exchange rate stable. The recent narrowing in short-dated yields between the US and major trading partners has undoubtedly taken some steam out of the dollar's rally.

In terms of the next move and based on our current monetary policy forecasts, this dollar correction might have come far enough. Unless one is prepared to call time on the Fed tightening cycle – and it seems far too early to do that – it seems likely that the dollar can make a run back to its highs. Last month we said that a 1.05-1.10 EUR/USD trading range had shifted to a 1.00-1.10 range – and that still feels about right.

US vs. G9 yield spreads

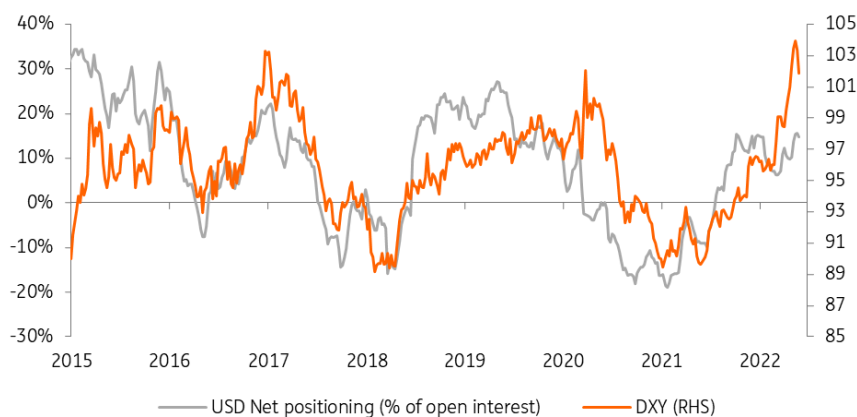


Source: Macrobond, ING

Dollar positioning is not stretched

We also think that speculative positioning should not stand in the way of a further dollar rally this summer. Yes, speculators have quite substantial long dollar positions on board. Yet these are nowhere near as stretched as in early 2017 (Frexit) or summer 2019 (Trump's trade war). Indeed, one could argue that fundamentals have driven the dollar to these highs and if anything, speculators could add to these long positions should they so choose.

Speculative long dollar positioning is not extreme



Source: CFTC, Macrobond

Fed pause prompts interest the carry trade

There are many investment strategies in financial markets geared against volatility – i.e. assuming that expected levels of volatility are too high. In the FX market, one such strategy is the carry trade, where an investor assumes that a high-yielding currency does not depreciate as much as is priced into the FX forwards market. However, realised volatility levels over recent months have actually been very high and have discouraged investors from chasing high yield returns – those returns largely found in emerging markets.

That said, there are early signs that the Fed pause is encouraging fresh interest in carry trades – especially in Latin America and Eastern Europe. These regions have seen some of the most hawkish central banks in the world, with implied yields through the three-month FX forwards ranging from anywhere in the 6% (Poland) to 12% (Brazil) region. Clearer signs that the dollar bull trend had peaked would certainly help the carry trade. Overall, we feel it is too early for these strategies in that central banks are rushing for the monetary exits and tighter liquidity conditions are typically consistent with higher, not lower levels of volatility. As such, we think carry trade strategies still require a health warning.

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