

FX: Dollar remains in demand

Having proven to be the strongest G10 currency over the third quarter, the dollar should also perform well in 4Q. Keeping the dollar bid are familiar themes such as expensive dollar hedging costs and unattractive investment stories outside of the US. We can't see these themes changing anytime soon and expect EUR/USD to trade between 1.05 and 1.10 in 4Q



Dollar hedging costs remain exorbitant

Dollar hedging costs have marginally increased over recent weeks on the back of the tightness in US repo and money markets. Unless the Federal Reserve looks to address these concerns through the meaningful addition of permanent liquidity, any further spikes in short-term dollar rates should add to dollar strength. Indeed, there are some further US tax deadlines in October (contributing to tight liquidity conditions) and EUR/USD has actually declined in each of the last five Octobers.

From the euro side of the EUR/USD story, the European Central Bank will restart asset purchases in November. In addition to increasing excess reserves at the ECB, asset purchases and forward guidance should root euro area interest rates to the floor and keep USD hedging costs above the 2.5% level. With the yield pick-up on a 10-year US Treasury versus a German Bund 'only' 2.25%,

hedging the FX exposure for European investors holding US debt is clearly too expensive.

EUR/USD versus 3m annualised FX hedging costs



Source: Bloomberg

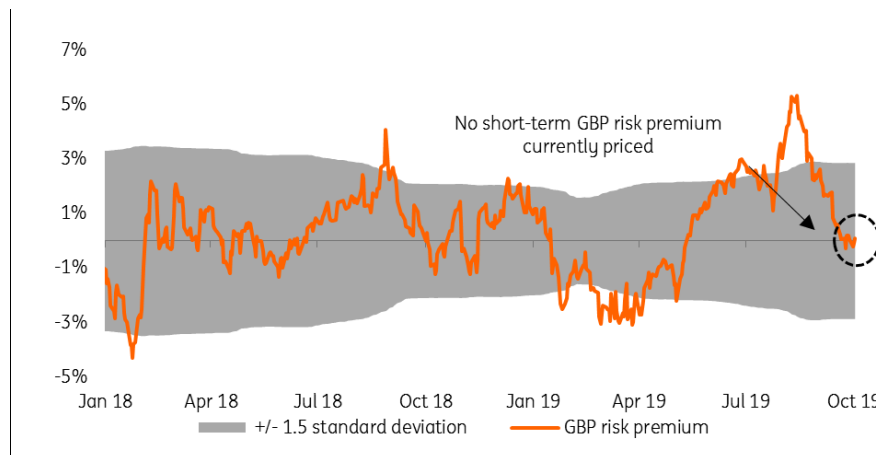
Alternative ideas

As we discussed last month, it will probably take some better news on trade relations (we struggle to see any before year-end) or some collapse in the US outlook (prompting a much more aggressive Fed easing cycle) to take the shine off the dollar. A US equity correction could prove a risk here, but with the Fed having applied the handbrake to further easing (if the Fed Dots are to be believed) the bar for a major dovish re-assessment from the Fed is high.

An additional very low-probability, very high impact FX risk would be if Washington's trade war with China were to spill over into the financial sector. The suggestion, quickly denied by the US Treasury, that Washington could restrict Chinese firms' access to US equity listings would mark a serious deterioration in relations and in the first instance send USD/CNH and USD/Asia sharply higher.

Elsewhere, the Brexit drama continues. The likelihood of Article 50 being extended into 1Q20 postpones but does not remove the risk of a No Deal Brexit. In fact, we think there is too little political risk premia priced into GBP currently. Typically, political risk premium can easily be worth 5-6% for GBP and as such, our bias is for EUR/GBP to trade towards the 0.94/95 area amid confidence votes, elections and No Deal risks throughout the quarter.

EUR/GBP risk premium - the residual between EUR/GBP short-term financial fair value and spot



Source: ING

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