

## FX: Is this the big turn in the dollar?

The drop in US interest rates has undermined the dollar. If this is the start of the long-awaited dollar decline, we expect it will be USD/JPY that leads the charge. Macro-political challenges in Europe mean that EUR/USD will struggle to better the 1.15 level



Source: iStock

The market is now convinced that the Federal Reserve is going to embark on an easing cycle. Many of us in the market had felt that the dollar was going to peak this year, but is the recent dollar sell-off really the start of the big turn we're all expecting?

Despite the massive 60 basis point decline in US market interest rates at the short end of the yield curve, the trade-weighted dollar is less than 2% weaker. We believe that this is down to two main factors.

### Interest rate differentials are still very wide

First, despite the recent narrowing, interest rate differentials are still very wide. We estimate two year US rates would have to fall another 25-50bp to drop into the zone where correlations between the dollar and rate differentials re-connect. Second, there needs to be a compelling story in overseas economies to attract funds away from the US. Given the nature of the current headwinds – global trade – those attractive stories overseas simply don't exist.

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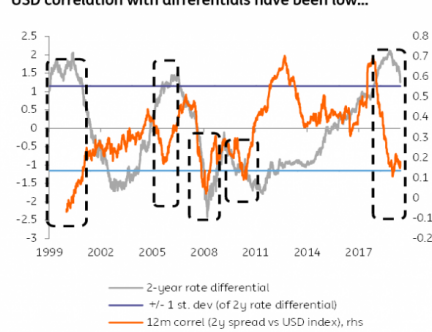
Also important to consider here is whether this is the start of a major Fed easing cycle, typified by reflationary bullish steepening of the US yield curve and a weaker dollar – or whether the 2H19 Fed easing we forecast is more like the quick insurance rate cuts that the Fed made in late 1998, which effectively prolonged the US expansion and the dollar bull trend into 2001? The prospect of a US bi-partisan infrastructure spending deal in 2020 means the latter scenario cannot be completely discounted.

**Bullish re-steepening typically means a weaker \$**



Source: Bloomberg, ING  
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**USD correlation with differentials have been low...**



Source: Bloomberg, ING

## It's too early to revise our 2019/20 EUR/USD forecasts

However, we would say that if this is the start of a significant dollar bear trend, we would expect it primarily to be played out against the defensive currencies of JPY and CHF. This is premised on the view that the trade war continues to escalate and the associated secular stagnation fears. We are thus revising down our year-end USD/JPY forecasts closer to 100 and would expect the JPY to strengthen on the FX cross rates.

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Softer US rates have lifted EUR/USD off the lows of the year, but we think it is too early to revise our end-year forecasts of 1.15 and 1.20 for 2019 and 2020 respectively. Soft eurozone growth and inflation, the real prospects of fresh European Central Bank stimulus, auto tariffs, Italian political challenges and finally Brexit all argue that the EUR should not lead the FX charge against a weaker dollar.

This month we are also revising our GBP forecasts lower. We see EUR/GBP trading up to 0.92 (Cable to 1.22) and possibly to 0.95 ahead of the October 31st Brexit deadline as investors fret over 'no-

deal' or early election risks – both perceived as GBP negative.

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