

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?

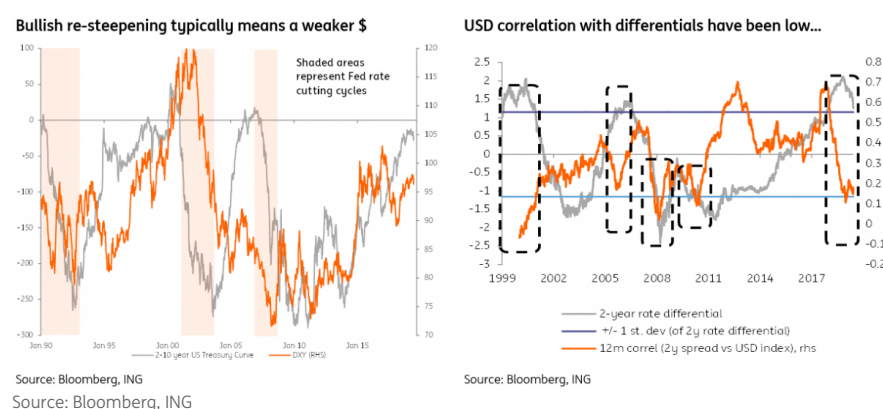
Despite the massive 60 basis point decline in US market interest rates at the short end of the yield curve, the trade-weighted dollar is less than 2% weaker. We believe that this is down to two main factors.

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.

We think 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

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.



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.

We've revised down our year-end USD/JPY forecasts closer to 100 and would expect the JPY to strengthen on the FX cross rates

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.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.