

FX: Dollar disinflation trade gets postponed

February proved a counter-trend month in FX markets, where firm US activity and price data saw the dollar reclaim a third of its losses since last October. March looks set to be a mixed month for FX, where presumably a hawkish Fed can keep the dollar supported a little further. It looks like the broader dollar bear trend will have to take a short raincheck



U.S. Federal Reserve
Chair Jerome Powell

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In data we trust

Dollar strength in February was really a function of incoming data rather than central bank speak. In fact, Federal Reserve Chair Jerome Powell proudly started the month by saying that the broad disinflation trend had started – a view quickly shelved by the market after the strong January releases of US jobs and core PCE price data.

Will February's dollar gains be quickly reversed? There is a scenario where US activity data reverses lower this month from inflated January levels – those high readings driven by warmer weather and aggressive seasonal adjustment factors. And should the housing slowdown start to feed into

official rental statistics, core PCE could reverse lower too.

Yet the reason we doubt investors are ready to jump back into short dollar positions is the 22 March FOMC meeting. Here, the Fed will have little choice but to sound hawkish. And some upward revisions to the Dot Plot fed funds expectation should support the recent hawkish re-pricing of the Fed curve.

We have mentioned this several times before, but a severely inverted US yield curve is not conducive to the kind of benign dollar decline that seemed likely in January. And central banks tightening into slowdowns will generate greater headwinds for risk assets. This again is not a particularly positive story for pro-cyclical currencies such as the euro – at least in the immediate future.

Further adjustments to FX forecasts

Last month, [we raised our EUR/USD profile](#) and had felt that the second quarter could be the best quarter of the year for this pair. Sticky US inflation suggests that clear signs of disinflation may not emerge until the summer. We are therefore revising lower our EUR/USD forecast for the second quarter, where we now see volatility in a 1.05-1.10 range depending on the data. And we are pushing back our 1.15 EUR/USD forecast to the fourth quarter when our macro and rate strategy teams now look for the substantial compression in two-year EUR:USD swap differentials – a key driver of the spot rate.

Elsewhere, the Chinese recovery will continue to help the commodity FX bloc – though broader gains in this segment will not emerge until the second half when the Fed has greater confidence in disinflation. And one of the best-performing currencies in the world should remain the Mexican peso. This has been buoyed by some of the highest risk-adjusted yields and Mexico's position as a major beneficiary of 'friendshoring' direct investment trends.

Author

Chris Turner

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

chris.turner@ing.com

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