FX markets: The dollar, asset markets and the global cycle

FX markets have entered a consolidative phase as they attempt to second-guess the next move from the Federal Reserve. That has allowed the dollar to correct 3-4% lower, continuing its negative correlation with global equity and debt markets. Yet, we still feel it is too soon to call a major turn in the dollar

The dollar broke to new lows for the year after the Fed's press conference

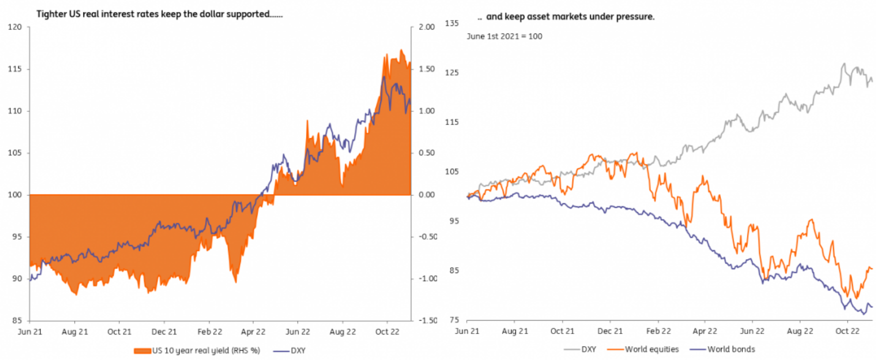
The Fed is not done with the dollar yet

Looking at the year-to-date FX performance in the G10 space, it has clearly been a good year for the dollar. More restrictive US monetary conditions have seen the dollar rally from as little as 7% against the Canadian dollar to as much as 22% against the Japanese yen. In response, Japanese authorities have initiated an FX intervention campaign to support the yen – currently worth more than $60bn.

Central to the dollar story has been the Fed and its desire to get inflation under control. The sharply inverted US yield curve is a good signal of the Fed "getting ahead of the curve". Another is US real rates. Here, nominal rates adjusted for inflation expectations have moved from deeply negative in the summer of 2021 – when the Fed shifted policy – to restrictive levels today. For example, the real US 10-year yield has moved from -1.00% to +1.50%.

Our rates strategy team believes that, over the next couple of months, the direction of travel for US real yields is higher still. A 2.00% level on the US 10-year real yield is entirely possible as the Fed takes the policy rate towards 5.00%, dragging long-end yields with it. That should keep the dollar bid across the board.

Real interest rates drag the dollar higher, hit bond and equity markets



Source: ING calculations

When will asset markets turn?

We think it is always worth considering FX markets in the context of the global economic cycle and looking at the performance of the dollar relative to major asset markets, such as bonds and equities. Clearly, it has been a bad year for both bonds and equities, where global benchmark indices for both groups are down roughly 20% year-to-date. The narrative here is that after the sustained period of easy money, both bond and equity markets are suffering as central banks seek to rein in liquidity.

It is quite rare to see both bond and equity markets hit equally hard at the same time. Typically, one might expect equity markets as the last asset market to turn before a recession, with bond markets starting to outperform when it becomes clear that tightening cycles are over. In fact, there have been some signs of this pattern developing already in Latin American debt. This region saw early and aggressive tightening cycles (especially in Brazil), which now look to be over. Latam local currency government bond indices are near flat on the year, versus 32% and 13% declines for EMEA and Asia equivalents.

We mention this because the turn in global bond markets should provide the first real opportunity for money to be put back to work in asset markets – potentially at the expense of the dollar. Looking at FX correlations with global bond indices this year, the Japanese yen and the Swiss franc have actually had the highest correlations, suggesting USD/JPY and USD/CHF might lead a dollar turn if and when it happens. Our base case, however, is that this is not a story until early 2023.

Before then, we see EUR/USD staying under pressure this winter. Sub-0.95 levels are possible. Japan's campaign to slow the USD/JPY advance should not prevent further forays over 150. And GBP/USD can easily trade at sub 1.10 levels as the tight fiscal and less hawkish monetary policy wins through in a still difficult external environment.

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