

Pressure builds on the dollar

‘Treading water’ is probably the best term to describe dollar price action this summer. However, that soon may be replaced with ‘that sinking feeling’ as the restart of the Fed easing cycle triggers another wave of dollar hedging activity



In his final meeting as Fed Chair, Jerome Powell could be asked questions about the Fed's balance sheet

The Fed should be a dominant factor

Somewhat surprisingly, the dollar has not sold off much further this summer. In fact, it has not gone far at all. But don't confuse some temporary stability with emerging strength. Certainly, the Fed story looks set to drag the dollar lower into year-end.

The question, however, will be: what kind of dollar decline will we see? Will it be a benign decline that keeps risk assets bid as the Fed credibly cuts rates back to neutral (3.00/3.25%) while avoiding a recession? Or will it be a more precarious descent driven by increased political pressure on the Fed as the White House seeks to secure ‘a majority’ on the board of what should be an independent Federal Reserve? We expect the former, while being alert to the latter.

Either way, we expect to hear a lot more about the potential for negative US real rates into year-end as the Fed shifts policy back to neutral and potentially even into accommodative territory.

And the big rallies in gold and digital assets serve as a reminder that the dollar will be vulnerable to a pick-up in inflation at a time when the Fed's inflation-fighting powers are being questioned. We

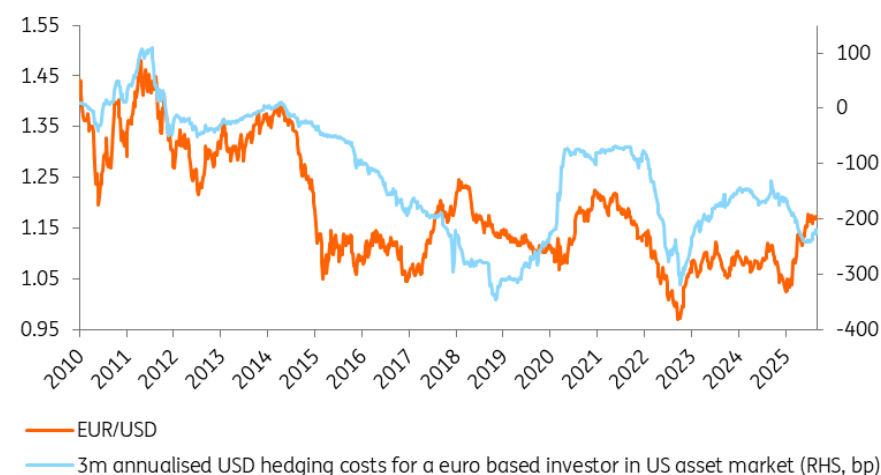
suspect we might hear as much about 'negative real rates' over the coming months as we have heard about 'fiscal dominance' this summer – the latter being the threat that the Fed will have to cut rates to service increasingly shorter durations of US government debt.

1.20 remains the EUR/USD target

Lower US rates will make it cheaper to hedge dollar assets. From around 2.2% per annum today, it looks like three-month dollar hedging costs for a euro area investor will drop to around the 1.00% area over the next six to nine months. That is generally consistent with a higher EUR/USD and returns to that theme which hit the dollar in the second quarter – namely, investors in US assets raising hedge ratios without necessarily selling the underlying asset.

The fact that the European Central Bank has likely finished easing now supports the above theme, and we expect EUR/USD to gain upside momentum in the November/December window – seasonally a weak period for the dollar.

Dollar hedging costs look set to cheapen



Source: Refinitiv, ING

We also remain bearish on USD/JPY, but will take close note of the direction of Japanese government policy. A more fiscally expansionist prime minister who leans on the Bank of Japan to go slow with policy normalisation could delay our forecast drop for USD/JPY to 140. However, the upside for USD/JPY should be relatively limited. The pair trades well above where short-term interest rate differentials suggest it should be trading. And we suspect both Tokyo and Washington will not want it to trade too much over 150, which would be at odds with Washington's plan for a smaller Japanese trade surplus.

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