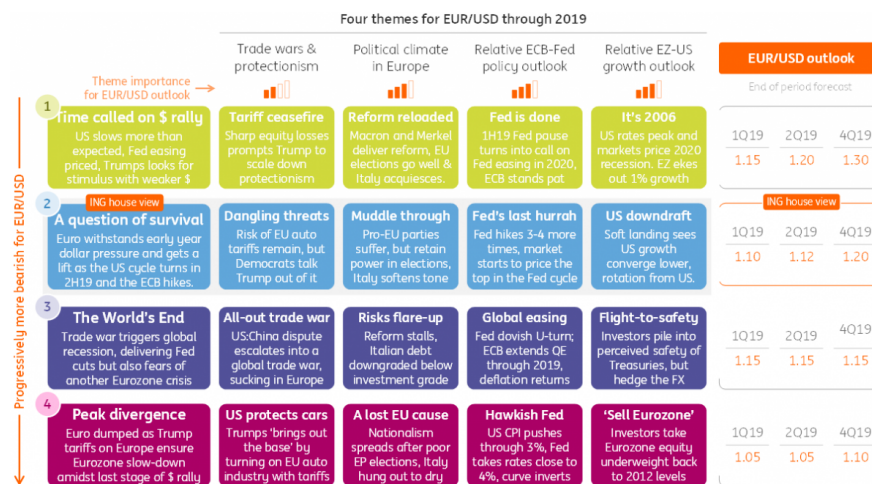


FX: Patiently waiting on the peak

As 2019 progresses, expect to hear more about a Fed pause. US market interest rates typically turn lower before the top in the Fed cycle. And if we're right about our call for a Fed peak in the third quarter, we suspect that undervalued risk assets can breathe a sigh of relief and the dollar will embark on an orderly sell-off



Source: ING

It is too early to call a top in the dollar. The Fed is now in the realm of late-cycle tightening and should deliver four more hikes. Dollar hedging costs will remain extremely expensive and, barring a US-centric shock, we would expect to see marginal new dollar highs against the euro and the Japanese yen over the next six months.

As 2019 progresses, expect a bearish dollar narrative to develop. US rates should be coming off their highs by the end of the year and as US growth converges lower on the rest of the world, expect investors to rotate out of US asset markets. A search for alternative sources of stimulus may also see the White House favour a weaker dollar.

Europe has been a big disappointment in 2018. Though sluggish growth has been blamed on a relentless stream of 'one-off factors', it is hard to see a significant pick-up in activity next year. EUR/USD will struggle to make it above 1.20 as the ECB barely lifts rates off the floor. European Parliamentary elections in May will also be in focus.

A lower EUR/USD in the early part of the year is typically not good news for CE4 currencies. The

good news is that the Hungarian forint and Polish zloty are already undervalued, while the market's favourite villain – the Romanian leu – is too expensive to sell. The Czech koruna should hold gains.

On Brexit, UK parliamentary approval of the Withdrawal Agreement may not be seen until February. Even if the deal is passed, 2019 is unlikely to look pretty as both the UK and the EU struggle to define what the ultimate relationship should look like. Expect the pound to continue to trade on volatility levels more common in emerging markets.

For EM, the gales blowing out of the US look set to continue through early 2019. Add in declining world trade volumes and rising late-cycle volatility and the EM environment looks challenged. But EM currencies have already discounted a lot of bad news. If they can survive the first half, modest rallies should be seen later in the year.

Within the EM space, we see China's renminbi steadily weakening all year as the economy adjusts to the US trade agenda. Our USD/CNY target is 7.30. In theory, a softer environment for crude oil prices in 2019 – we see Brent trading more in the US\$60/bbl area than the US\$70/bbl area – should be good for Asia. Assuming the Indian rupee can survive elections in May, central bank tightening in 2H19 should allow the currency to take advantage of the softer dollar story.

The big beasts of Latam, Brazil's real and the Mexican peso, will continue to see substantial volatility as investors adjust to the new political reality. Argentina aside, better external accounts, low inflation and faster GDP growth suggest more resilience in the region. However, Brazil's ability to pass fiscal legislation will very much set the tone early next year.

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