FX: Protectionist risk premium in the US dollar

We retain EUR/USD targets at 1.30 for end 2018 and 1.35 for end 2019

The year has started strongly for risky assets – especially equities. The theme of synchronised global growth, re-rating stories outside of the US and dollar weakness is now a familiar one. We have characterised this as a 'benign decline' in the dollar and it is on this which we base our year-end EUR/USD forecast of 1.30.

Read: FX Hot Topics: A 'Mercantilist and Mercurial' Dollar Policy

Emergence of protectionism and a mercantilist dollar policy

Yet over recent weeks, we have also seen the emergence of some less benign factors such as US protectionism and a mercantilist approach to dollar policy. We now expect investors to build a protectionist risk premium into the dollar, prompting us to revise our USD/JPY forecasts lower.

Let's look at the two key developments here:
(1) President Trump agreeing to anti-dumping tariffs to protect US manufacturers of washing machines and solar panels; and
(2) Treasury Secretary Mnuchin's comment that a weaker dollar is good for trade.

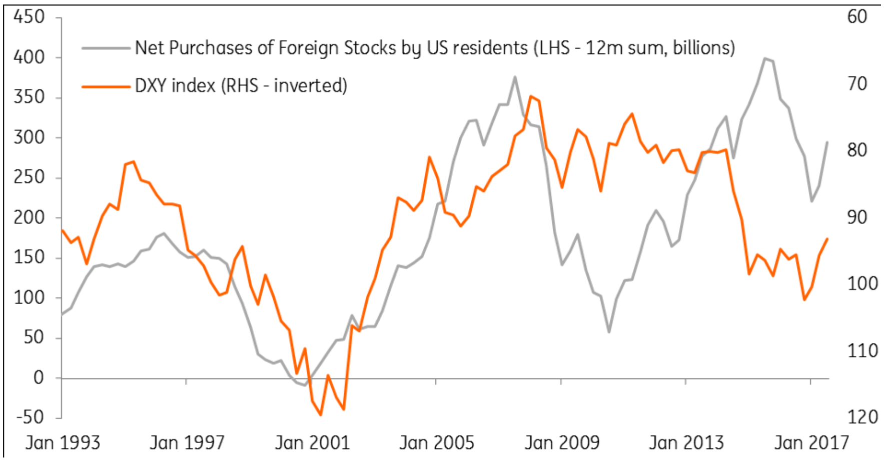
Both developments could be dismissed as 'noise'. We would counter that:

(1) this is the first time these particular safeguard tariffs have been used since 2002; and
(2) President Draghi did not regard Mnuchin's remarks as casual and instead publicly rebuked him for seemingly encouraging a weaker dollar for trade gain.

Clinton Administration took over a year to put the genie of a weak dollar policy back in the bottle

In particular Mnuchin's remarks recall a very similar (and failed) dollar policy employed by the US Treasury in the early-1990s. At the time it was seeking to narrow the US trade deficit with Japan. Having encouraged a weaker dollar in 1993/early-1994 and inadvertently contributed to a Treasury market sell-off, it took well over a year for the Clinton Administration to put the genie of a weaker dollar back into the bottle – and what we now know as the US Treasury's strong dollar policy was born in April 1995.

US investors put money to work, dollar weakens



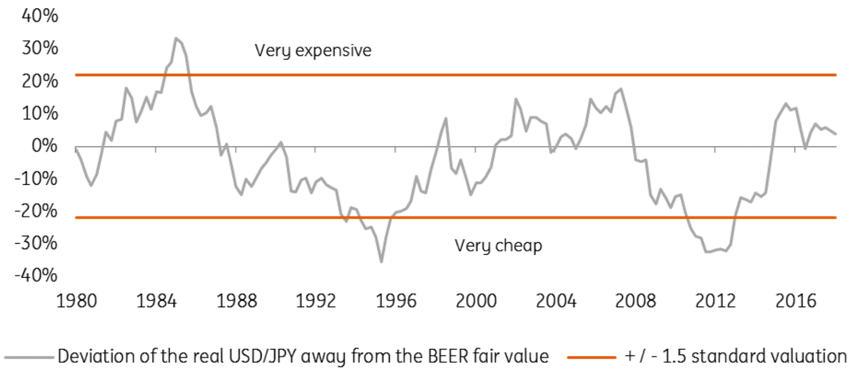
Source: ING, Macrobond

Why our revised year-end target of 100 is not particularly excessive

How much could the risk premium damage the dollar? Back in the early-1990s, USD/JPY traded more than 30% below ING's fair value estimate based on medium-term fundamentals. That fair value calculation now stands at 105 – suggesting our downwardly revised year-end target of 100 is not particularly excessive. It also reflects the fact that the world economy is now in a lot better shape than the early-1990s.

USD/JPY versus term fair value estimates

%, positive number signifies USD/JPY over-valuation, negative number signifies under-valuation; Fair value as of Q4 2017; Current spot



Source: ING

Bottom line

The protectionism story aside, it still seems investors are willing to put money to work. US Exchange Traded Fund (ETF) flow data shows continued strong demand for US, Emerging Markets, European and Japanese equities (in that order). Assuming global activity remains on an upswing, we expect US investors to continue to put money to work overseas – keeping the dollar on the back foot. We retain EUR/USD targets at 1.30 for end-2018 and 1.35 for end-2019.

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.

 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