

FX: Re-pricing for a shock

FX markets are in the process of adjusting to the coronavirus news – largely seen as a Chinese demand shock. If the virus was to start weighing heavily on activity outside of China – especially in the US – then the dollar might have to re-price lower as well



A trader working on the floor of the New York Stock Exchange.

Source: Shutterstock

Commodity currencies adjust

The initial reaction in FX markets to the news of the coronavirus has been the sell-off in the commodity currencies. This complex had been well supported since late last year – after the phase-one trade deal. Yet that optimism has now evaporated. Given that China consumes around half of the world's commodities, it has been no surprise that commodity currencies have been dragged lower in line with the 13% fall in key benchmark commodity indices.

Those currencies most exposed to both commodities and equities are thus the most vulnerable to this China demand shock

Flattening yield curves around the world have also been representative of declining growth

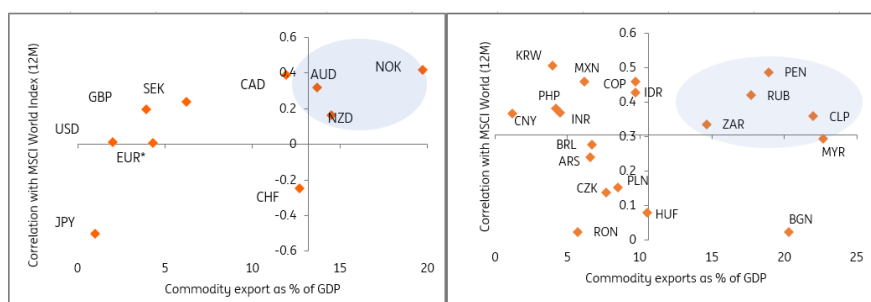
expectations. This has had ramifications for corporate profit expectations and equity markets, prompting those currencies most correlated with equities to underperform as well. Those currencies most exposed to both commodities and equities are thus the most vulnerable to this China demand shock. In the G10 space, this means AUD, NOK and NZD while in the emerging market space, this means CLP, RUB, PEN and ZAR.

Additionally, those countries most dependent on tourism – especially Chinese tourism – have seen their currencies sell-off. Thailand is vulnerable here. And while not a commodity exporter, South Korea’s strong macro links with China means that KRW is in the front line of currency weakness as well.

We suspect all of the above currencies will remain vulnerable through 1Q20 as investors track not only news of the virus, but also the fall-out on consumer and business sentiment and then ultimately the hard data as well. Any hope for a rally in pro-cyclical currencies now looks like it will have to be postponed to 2H20.

Looking at the those currencies most exposed to:

i) commodity exports and ii) correlation with equities



Source: ING, Bloomberg

Is the dollar immune?

The widely watched dollar index, (77% weighted against European currencies), has held up well since the start of the year. This despite the 20bp fall in two-year USD swap rates.

Driving this strength has largely been the malaise of European currencies and the fact that the dollar is still an expensive sell. Notably, the euro has not been able to make any ground against the dollar which we attribute to the substantial doubts about the European growth profile in 2020.

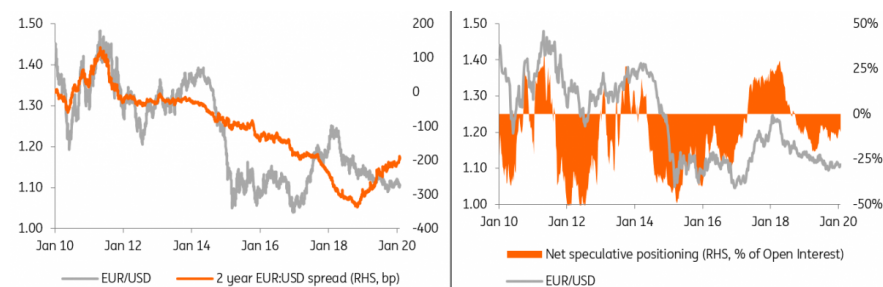
For the dollar to lose some of its safe haven appeal we will probably need to see some clear US-centric negative news. That could be concerns of the coronavirus hitting US activity and consumption or it could be the US presidential election risk

At the same time, the speculative community has been consistently running short EUR positions since September 2018 and has shown little appetite to scale those down substantially. This despite short term EUR: USD rate spreads having narrowed substantially since last summer. However, it still costs European investors some 2.2% to hedge dollar risk and we suspect these borrowing costs must narrow in another 50-75bp (i.e. the market price 100bp not 50bp of Fed cuts over the next 12 months) before the dollar starts to correct lower. This is especially the case since the expected EUR/USD volatility is still plumbing all-time lows below 5% (twelve-month EUR/USD volatility).

For the dollar to lose some of its safe-haven appeal we will probably need to see some clear US-centric negative news. That could be concerns of the coronavirus hitting US activity and consumption or it could be the US presidential election risk. Equity investors are keeping a wary eye on the Democrat nomination race. If Bernie Sanders or Elizabeth Warren were to start gaining momentum into Super Tuesday in early March, the prospect of their redistributive and regulatory confrontational agenda could start to demand a greater risk premium of US equities and the dollar.

However, that is not our base case, and we still hold that EUR/USD and USD/JPY trade rough 1.10-1.15 and 105-110 ranges respectively this year.

Despite narrowing yield spreads, speculators still run short EUR/USD positions



Source: Bloomberg, ING

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