

FX: Secular stagnation?

Yield curves are flattening in developed markets and it's unclear what will drive domestic demand in the US and beyond. This favours the dollar right now



USD: The balance of risks favours the dollar for the time being

Calling the next move in the dollar is pretty tough right now. The start of the year saw investors move into undervalued risk assets, but right now the mood is shifting towards one of secular stagnation. Yield curves are flattening in the developed markets space and it's uncertain whether the growth drivers of domestic demand (both in the US and elsewhere) are sufficient to keep the show on the road. How President Trump's decision to use emergency powers to fund the wall plays out will be judged through US equity markets and we would not be surprised to see some precautionary buying of the Japanese yen just in case the S&P 500 hands back some of this year's recovery. Going back to the secular stagnation story – were US trade negotiations to sour (be they with China or Europe) – and investors rotate to bonds from equity, the shape of the US yield curve

might still favour the dollar. A very flat curve makes it relatively expensive to hedge FX and a flight to the safety of US Treasury curve would likely be done with low FX hedge ratios. For today, the US data calendar sees industrial production, which should remain firm, while consumer sentiment should bounce back from January's sharp decline. Not enough evidence for a lower USD, so DXY at 97.70.

⬇️ EUR: Market-based inflation expectations plummet

The EUR 5 year, 5 year inflation swap forward, a common measure of market-based inflation expectations is now at 1.44% - that's lower than when the European Central Bank started its quantitative easing programme in January 2015. Two-year EUR swap rates remain slumped at -0.30%, limited by the deposit rate floor at -0.40%. Thus the mood may shift to talk of more, rather than less ECB stimulus. Lots of focus today on the largest weekly outflow from European equity funds since summer 2016 adds to the mood that Europe (and the euro) remain in quarantine from an investor perspective. A strong US IP figure today could send EUR/USD to 1.1220.

⬇️ GBP: Down to the wire

Sterline remains soft and may not receive any respite until 27 Feb, when the Cooper amendment may resurface. Unless retail sales surprise, cable risks 1.2670/2700.

⬆️ BRL: Encouraging news on pension reform

Brazilian markets enjoyed a bounce late Thursday on news that President Bolsonaro would send a pension reform bill to Congress on 20 February. ING's Gustavo Rangel sees the plans as more ambitious than expected and should be approved, although closer to the third than the second quarter. Brazil's fiscal deficit has been its Achilles heel (the current account deficit is a lot narrower now) and progress on pension reform could be a significant positive for the real this summer - potentially driving USD/BRL sub 3.50. For the shorter-term and given the tricky external environment, this news may perhaps keep USD/BRL under 3.80.

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