FX Talking: Soft Landing, Hard Landing, No Landing?

The dollar has started the year on a soft footing on the view that the Fed can respond to a soft US landing, as the Rest of the World recovers. The recent run of data, especially out of the US, questions whether the Fed needs to cut rates at all. On balance, we are backing the US disinflation process, lower US rates, and a weaker dollar. But it is a close call

No one said it was easy

Financial markets have started the year in rude health. Equity markets are up as much as 9% in Europe and some emerging countries. Narrow spreads are not stopping the huge supply of and demand for private sector bond issuance. And the dollar has continued to fall on the back of lower US rates.

The above environment reflects one of a 'soft landing', where softening US price pressures allow the Federal Reserve to cut in an orderly manner. This is a far cry from fears of a 'hard landing' last October. Back then, it looked like sticky inflation would force central bankers to hike into a recession. And now the most recent US data set of powerful January jobs growth and much better service sector confidence questions whether we will see any kind of US landing at all.

While cognisant of the risks, our preferred view falls along the soft-landing scenario. On the one side, our call is for US core inflation to decelerate sharply in the second quarter and provide room for the Fed to cut rates starting in September. On the other side, China reopening, lower gas prices and the powerful fiscal response in Europe leave the Rest of the World better positioned than last October.

Our baseline assumes better global growth and narrower yield differentials between US and eurozone policy rates drive EUR/USD towards the 1.15 area in the second quarter – not far from its new fair value. Beyond sticky US inflation and any reversal of Covid measures in China, one other risk to this more benign worldview would be a third quarter US debt ceiling crisis.

A higher EUR/USD should drag European currencies higher too. However, it now looks like EUR/GBP and EUR/CHF will both trade higher through the year. And one of the biggest risks of a hard landing is probably in Sweden, where high inflation may prevent Riksbank support to a housing market now falling 15% year-on-year. Elsewhere in Europe, demand for yield should keep the Hungarian forint and Czech koruna in demand, whilst the Polish zloty continues to lag. February may bring fresh news on Poland's long-running FX mortgage saga.

The upward revision to global growth forecasts is seeing renewed demand for commodity currencies. Our preferred choice here is the Australian dollar, where an improved trading relationship with China and an under-priced Reserve Bank of Australia tightening cycle could see AUD/USD trade up to 0.75. The New Zealand dollar may lag, saddled by the fallout of high rates in the housing sector.

In Asia, USD/JPY should dominate in February. The term of uber-dove Bank of Japan governor Kuroda expires in April. We should know more about his successor this month. We doubt the yen has to hand back too much of this year's gains. Assuming our broad Fed/dollar view is correct, USD/JPY should be trading closer to 120 as the year progresses. China's reopening should keep USD/CNY and USD/Asia, in general, gently offered.

Finally, Latam continues to face political challenges. Despite the prospect of a strong year for the commodity complex, the Brazilian real may underperform. Not only are there fears of the new Lula administration breaking debt ceiling limits, but it now seems the government is taking aim at the central bank too – potentially pressuring rate cuts and pushing for a new – higher – inflation target. Much better placed is the Mexican peso. If the recent drop in rates volatility continues, the peso should remain the carry trade target currency of choice – with some of the best risk-adjusted returns.

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