# FX: The dollar downtrend remains on hold

We had previously pointed at the third quarter of 2023 as the period where the dollar would decisively turn lower. Recent developments in US data and Fed communication may well have delayed the big chunk of the USD decline, but medium-term valuation and our expectations for Fed rate cuts in early 2024 mean EUR/USD can still eye 1.15 around the turn of the year

The dollar outlook is likely to remain strictly tied to Fed rate expectations

## A prolonged pause in the dollar decline

In previous rounds of forecasting, we had pointed to the third quarter of this year as the period where a dollar downtrend could truly materialise, as the combined evidence of slowing inflation and the economic slowdown would lead the Federal Reserve to a dovish turn. Now in July, we have to acknowledge that it may still be too early for the dollar to take a decisive and sustainable turn lower this summer.

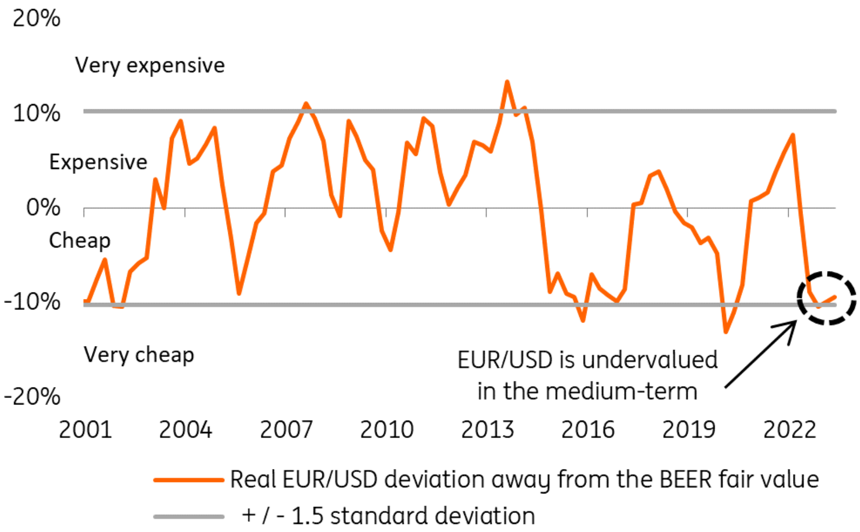
The recent strengthening in FX with short-term rate correlations means central bank divergence remains generally the predominant driver across USD crosses, and the dollar outlook is likely to remain strictly tied to Fed rate expectations. Our rates team believes a drop in short-term USD rates now looks more likely to be a fourth-quarter and early-2024 story, which means EUR/USD could mostly bounce around the 1.08-1.10 range this summer, without a very clear sense of direction, before taking a decisive turn higher to 1.15 by year-end.

The ECB's hawkishness, underpinned by sticky core inflation in the eurozone, can help keep frontend EUR swap rates supported, and offer more support to the euro, but is also unlikely to do the heavy lifting in a longer-lasting EUR/USD bull trend. We expect two ECB hikes, in July and September, and only a gradual abatement of the hawkish rhetoric. Markets however are fully pricing this in, and the magnitude of potential Fed expectation repricing remains considerably larger compared to the ECB's.

## Valuation points to higher EUR/USD

The reasoning behind sticking to our medium-term bullish view for EUR/USD is primarily, but not only, bonded to our core view for a shrinking USD-EUR rate short-term rate gap. Our BEER model – which tracks real medium-term mis-valuation based on economic fundamentals – shows EUR/USD is still around 8-10% undervalued. That mis-valuation gap has remained quite wide because the sharp rebound in the eurozone's terms of trade (thanks to lower energy prices) has not been matched by a similar recovery in EUR/USD, which has been held back by the Fed's large tightening cycle. We believe the dovish shift by the Fed – albeit its timing remains uncertain – will prove to be the trigger to a reconnection with unequivocally bullish fundamentals for EUR/USD.

## Economic fundamentals suggest EUR/USD is cheap




Source: ING

## Domestic tightening stories remain key across the G10

Since the dollar is overvalued against all G10 currencies except for CHF, according to our BEER model, the same reasoning can be applied to the more general spectrum of USD crosses. Incidentally, we could see domestic stories – especially on the central bank side – dominate before a clearer dollar trend emerges later in the year.

In the UK, the Bank of England's aggressive fight against ultra-sticky inflation should keep the GBP curve highly inverted, which can ultimately keep a reserve currency like the pound supported for longer. Japanese authorities look once again on the brink of FX interventions, as USD/JPY trades close to the 145.00 mark, but some help for the yen might actually come from a hawkish tweak to the yield-curve-control policy by the Bank of Japan this summer.

In Europe, Scandinavian central banks are deploying FX-supportive tightening packages. We favour

NOK over SEK thanks to a more hawkish Norges Bank stance and elevated domestic risks in Sweden.

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