

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.

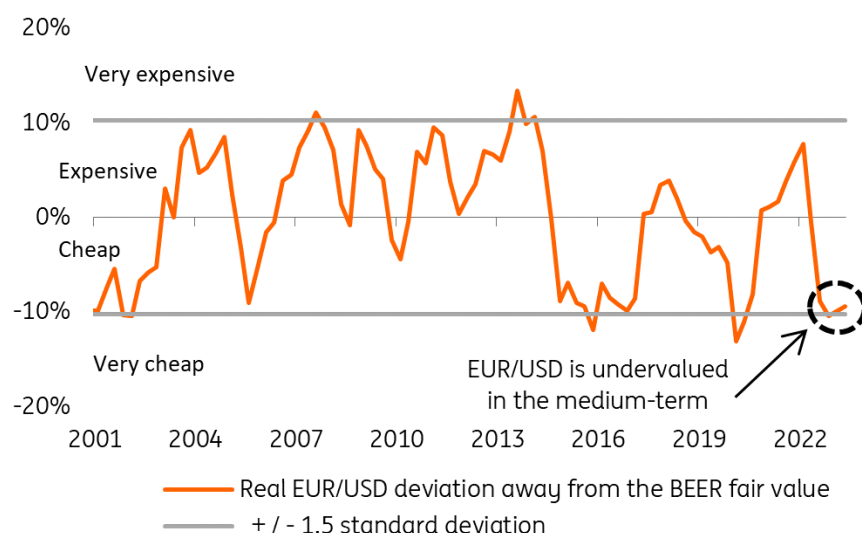
The ECB's hawkishness, underpinned by sticky core inflation in the eurozone, can help keep front-

end 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.

Author

Francesco Pesole

FX Strategist

francesco.pesole@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.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. 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 the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.