

FX: The normalisation game

FX markets have entered May split down the middle. Outperforming are the commodity currencies enjoying the global recovery cycle and backed by central banks considering tighter policy. Underperforming are the defensive low-yielders, with very distant prospects of rate hikes. The dollar is caught in the middle



In the balance

April saw the dollar hand back nearly three-quarters of the gains it made in the first quarter of 2021. The rationale looked to be some calming at the long end of the US Treasury market, which managed to switch the narrative away from a re-pricing of risk assets and towards recovery stories in the Rest of the World.

Commodity FX is leading the charge against the dollar

Into May and it is commodity FX that continues to lead the charge against the dollar. It is instructive to see that the currencies performing the best this year are those where the markets have priced the most monetary policy tightening over the next two years.

Notably, Norges Bank and the Bank of Canada are happy to discuss the timing of output gaps being closed and have allowed tightening expectations to build. In contrast, very little tightening is priced in the eurozone and Japan, and one could say EUR/USD has outperformed based on this tightening metric.

This brings us to the dollar. At the front of the queue when it comes to closing output gaps is the US economy. Yet the Federal Reserve's adoption of a new monetary policy strategy means the link between closing output gaps and tightening policy has been muddled – with the Fed preferring to tighten much later than normal.

As long as the Fed feels comfortable allowing the economy to run hot – and delaying its normalisation cycle – we think the dollar has a window to stay offered. This should allow EUR/USD to benefit from the European recovery story in the second half of 2021 and we retain a scenario of a move to the 1.25/28 region later this year. Such a move would be helped by continued progress on the EU Recovery Fund and perhaps also by the progress of the Greens in the opinion polls ahead of September elections in Germany.

Year-to-date performance versus \$ and the amount of monetary tightening expected



Source: Refinitiv, ING

A limited window for dollar weakness

As above, this window for dollar weakening against European FX looks limited. Currently, we would say it is a nine to twelve-month window. Yet this window would snap shut were the Fed to conclude that monetary normalisation should take place earlier than currently priced. The risks certainly seem to lie in that direction, but for the time being the Fed seems to be holding the line and trying to ride out the spike in US activity and prices.

In the event of a hawkish surprise from the Fed and presumably bearish flattening of the US curve, we would have to reappraise our core 2021 view of a benign decline in the dollar. And an early withdrawal of the Fed's punchbowl could certainly prompt some market dislocation and dollar strength against the G10 FX commodity complex and emerging market currencies in general.

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