FX: Timing the dollar decline

The dollar is around 10% off the highs seen in late September, and understandably the view is that the dollar bull cycle – which started summer 2021 – is well and truly over. Consensus expects the dollar to weaken further this year, and we agree

Dollar bear trend could pick up speed in the second quarter

At the heart of the bearish dollar view is the call that the Fed will shift to a reflationary stance in the second half of 2023, US short-dated yields will fall and those yield differentials will move against the dollar. This story should be particularly acute for EUR/USD, where sticky core inflation in the eurozone means that the European Central Bank will not be considering rate cuts until late 2024.

At the same time, lower natural gas prices have seen the eurozone terms of trade improve markedly and justify fundamentally higher levels of the euro. Assuming that the China reopening story continues to evolve positively, we think this confluence of factors can drive EUR/USD steadily higher throughout 2023. Most of the gains, however, may come in the second quarter, when US inflation is seen falling quite sharply.

Sustained EUR/USD gains beyond 1.15 may be harder to achieve in the second half – especially if US debt ceiling negotiations are pushed to the limit. Some would argue that the US debt ceiling is a bullish factor for the dollar – prompting a flight to quality. Yet the evidence from 2011 proves the contrary. Only were the US very close to an unthinkable sovereign debt default – i.e. extreme risk aversion – would the dollar derive any brief benefit.

USD/JPY should continue to fall throughout the year. Bank of Japan meetings will prove positive event risks for the yen as investors second-guess how quickly a new BoJ governing team will unwind the current very dovish settings. We target 120 here and the yen should outperform on the crosses whenever the benign investment conditions are challenged.

Sterling is trading on a slightly steadier footing as the UK government attempts to restore fiscal credibility. The marginally better global investment environment is also helping the risk-sensitive pound. Sterling may hold its gains through the first half of the year as the Bank of England stays hawkish. But clearer signs of easing labour market and price pressures in the second half of 2023 will see conviction build of a forthcoming BoE easing cycle. EUR/GBP may well be ending the year nearer 0.90/91.

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com