

FX: Timing the dollar sell-off is now the key challenge

Fast support for the US banking system has seen the dollar turn lower from distressed highs as investors have switched to focusing on easing from the Federal Reserve. Conviction levels are rising that the dollar will sell off – but timing remains key as ever



Dollar to exit this banking mess to the downside

The 2008 Global Financial Crisis and the more recent Covid-19 pandemic provide a good playbook for how the dollar performs in a crisis. First, it lurches to the upside on the confidence crisis in inter-bank funding. No one gets fired for being long dollar balances in a financial crisis. But once authorities introduce measures to improve liquidity – be it new schemes or re-introducing old ones – the dollar tends to sell off on the assumption that market functioning has been solved and that the Federal Reserve can cut.

The above roughly explained how the dollar performed in March, but the question now is whether the dollar can leave the banking crisis behind and focus on the forthcoming Fed easing cycle. Our forecast profile assumes that conditions will remain tense in the second quarter and that the Fed still wants to tighten. Here, we expect EUR/USD to continue bouncing around the 1.05-1.10 range. Into the second half of the year, however, the deceleration in US price and activity data – plus some Fed acknowledgement of these broad trends – should see the dollar break cleanly lower. We continue to target EUR/USD at 1.15 for year-end.

The path to a weaker dollar will be a bumpy one and could easily get blown off course should banking stress return or other challenges emerge – such as a US debt ceiling crisis in the third quarter. Our preference would be for renewed Japanese yen outperformance on the crosses – especially if the Bank of Japan further adjusts its Yield Curve Control policy at its June meeting. Elsewhere, we remain suspicious of sterling's outperformance in March and expect it to come under pressure again – EUR/GBP to 0.90 – as the Bank of England moves closer to a formal pause.

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