FX: Why the dollar need not rally

We maintain a year-end forecast of 1.30 for EUR/USD

Source: istock

Dollar disconnect

One of the surprises towards the end of 2017 was how the dollar failed to derive much benefit from improving US growth prospects and the move towards pricing three Fed hikes in 2018. In our opinion, that disconnect was driven by the re-rating of growth stories overseas – especially in Europe. We expect this trend to continue in 2018 and maintain an end-year EUR/USD forecast of 1.30. Last year we were making the point that the 6% decline in the broad dollar index was driven by the re-rating stories in the likes of China's yuan, the euro, the Mexican peso and the Canadian dollar (comprising 64% of this index). We expect these trends, ex MXN, to largely continue – where early to midcycle recoveries are favoured, particularly by equity investors, compared to the later cycle story in the US.

Trump's policies unlike those of Reagan

We would also argue that comparisons between Trump’s reflationary policies are nowhere near those of Ronald Reagan in the mid-1980s, such that the dollar does not need to see a Reagan-style rally on US tax reform in 2018. Importantly back in the early 1980s, the European Economic Community (the precursor to the EU) unemployment rate was doubling, delivering a decisive growth differential between the US and Europe. Fortunately Europe is in a lot stronger position today and rising growth rates in major trading partners stand to limit the extent of US macro outperformance. On that subject, President Trump will welcome stronger overseas growth but will not want to see the dollar strengthen meaningfully. In fact, going back to the 1980s, the second and third years of Republican Presidencies have actually been the most negative for the dollar.

In the run-up to mid-term elections, it would not be a surprise to see Washington return to the issue of unfair trade practices and, by implication, the need for stronger currencies amongst key trading partners in Europe and Asia. Probably the biggest risk to our baseline of a benign dollar decline would be a US inflation break-out, prompting a sharp acceleration in Fed tightening and an inverted US yield curve – inverted yield curves are typically positive for currencies. For EUR/USD, we maintain a relatively flat profile through 1Q18 as the focus shifts to Italian electoral risks in early March. The upside break-out should come in the second quarter when the market resumes debate on the end of ECB quantitative easing and Bund yields are on the rise. In addition, the Euro should perform well as a safe-haven currency, should the investment environment become more challenging later in the year.

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