FX: Wrestling with the dollar bull trend

The eight-year dollar bull run is showing signs of fatigue – but is not giving up without a fight. We suspect that an escalation in trade tensions will prove the catalyst for a fresh bout of dollar losses – especially in USD/JPY

Source: iStock

It may take a while for a clean dollar bear trend to emerge

There are some signs that the dollar is topping out. And certainly, President Trump would expect a weaker dollar to do some of the heavy lifting if the US economy required more stimulus. However, the dollar is not giving up its gains that easily and we expect it may take a while for a clean dollar bear trend to emerge.

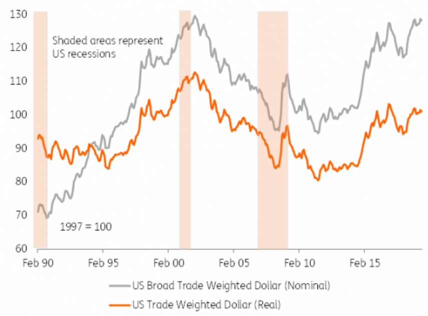
The past month has generally seen the dollar continue to edge lower – primarily against the defensive currencies of CHF and JPY. The decisive rally in Gold through $1400/oz provides some backing to the view that the dollar trend is turning and institutional investors now see the dollar as the most overvalued since 2002 – coincidentally as the Fed's trade-weighted, broad dollar index stalls at those 2002 highs.

What would it take to drive the dollar lower?

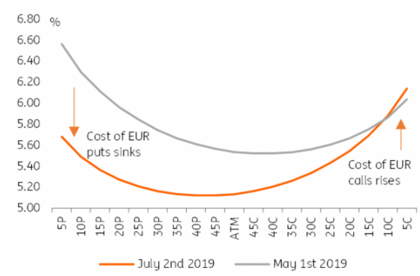
But what it would it take to drive the dollar substantially lower? A 25bp Fed cut on 31 July is fully priced in and it is hard to see short-end US rates falling a lot more – unless, that is, the US-China trade war takes a turn for the worse. As it happens, an escalation in the trade war is our baseline view this summer. Instead of lifting the dollar broadly on safe-haven inflows – we suspect trade tensions feed more directly into Fed easing expectations and generate further declines in the likes of USD/JPY and USD/CHF.

The nature of our expected 3Q19 dollar decline, one driven by trade tensions, warns that emerging markets FX may not repeat the kind of gains witnessed in June when reflationary Fed policy drove gains across the board. We would characterise the 3Q19 expected dollar decline as 'bad', rather than a 'good' dollar decline seen when the Fed front runs a downturn.

Is the dollar topping out?



EUR/USD 'smile' curve for 3m option prices



Source: Bloomberg, ING

The EUR/USD option market seems more impressed by the Fed story

We are also seeing a subtle shift in the FX option market's attitude to the dollar. In spite of ECB President Mario Draghi's threat to ease policy on 25 July, the EUR/USD option market seems more impressed by the Fed story.

In only a couple of months, the cost to buy downside EUR/USD protection has fallen sharply and the cost to buy upside protection has risen marginally. Changes in the shape of the FX option 'smile' curve reflects the shifting pattern of demand and suggest the market is moving towards greater concern over an upside break in EUR/USD.

> Yet it still looks far too early to call for EUR/USD to move higher given: i) ECB easing, ii) the threat of US auto tariffs on the EU and iii) Italy and Brexit – but certainly, trends in the FX options market are worth monitoring. As such, we still expect EUR/USD to trade in a 1.10-1.15 range into year-end, with GBP/USD trading down to the low 1.20 into late summer.

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