

FX: Dollar downgrade

Despite broadening lockdowns, the recovery trade in FX markets is in full swing and the dollar bear trend is showing no signs of slowing. Trying to time a correction is tricky and instead, we are focusing on lowering our end-year dollar forecasts



A man with a US dollar mask

The short-term outlook: Dollar downgrade

New Year early trading sessions have witnessed an extension of the FX trend we've seen since early November, namely a broad dollar decline. The central drivers here remain global recovery hopes backed by deeply negative US real rates. By successfully driving up US inflation expectations the Federal Reserve has successfully devalued the dollar.

As we move through the first quarter of this year, it is fair to say that recovery hopes will be challenged – especially in Europe. The return of national lockdowns are certainly taking their toll on activity and arguably European currencies should become more vulnerable.

Yet the powerful dollar bear trend is floating all boats, including the euro. And the re-cycling of money flowing into Asia, via FX reserve managers, into the EUR looks like one the European Central Bank will have to suffer all year.

The vaccine effect: Limiting any dollar corrections

Expectations that the vaccine rollout will allow economies to reopen in the second quarter of the year should mean that if we do see any corrections in the dollar trend, they will be reasonably shallow. Investors now know that central bankers, especially the Fed, stand very ready to offer more liquidity should recovery trends look to be stalling.

In practice, we think any corrective rallies in the dollar would peter out somewhere near the 1.20 area in EUR/USD and 105 in USD/JPY.

The strength of the recovery: Reflationary FX trends extend into 2H

As long as economies evolve in line with recovery hopes, we expect these reflationary FX trends to continue through the second half of 2021. Given these global trends favour the asset classes of commodities and equities, the commodity FX complex and Asian FX should continue to do well respectively. Here USD/CNY should be heading towards 6.20.

But the dollar should also stay pressured across the board and we now expect EUR/USD and USD/JPY to be ending the year closer to 1.30 and 100, respectively.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

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