Softer US story beginning to show in FX markets

Some softer US data has managed to pull the dollar away from its highs of the year. Our baseline Fed scenario should see the dollar drift lower over coming quarters, although the US elections remain the wild card. The USD/JPY rally has stalled too. Japanese FX intervention may again prove well-timed – as it was in 2022

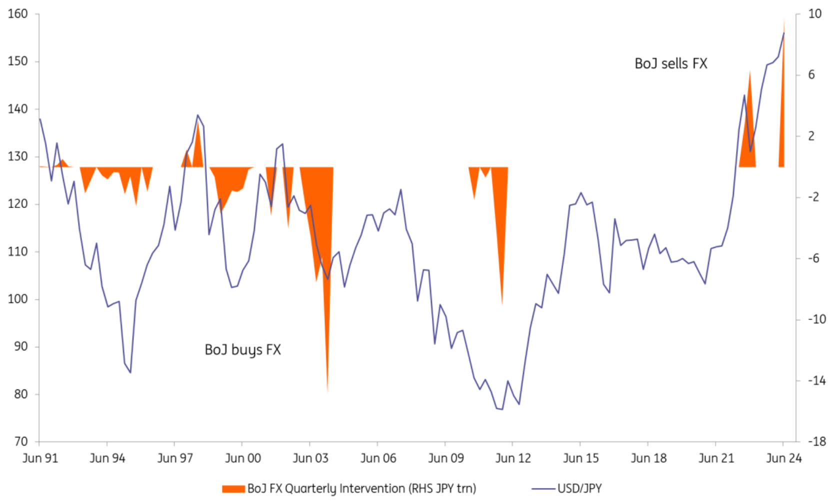
Notably, the yen was one of the strongest performers again in the last two months of 2023 when US rates turned lower

Softer US data turns the tide

Some softer US activity data – think April's jobs and retail sales reports – plus some less alarming US price data has seen the dollar correct around 2% lower over the last month. This may just be another example of the dollar thrashing around in ranges before the November US election. Or it could be a sign that a market positioned heavily long the dollar wants to lighten its load just in case the US data is about to swing softer and provide the Federal Reserve with the confidence it needs to start an easing cycle.

Given that the market prices barely more than one Fed cut this year, our house call of three cuts should finally deliver some softening in short-end US rates and a weaker dollar. Some may argue that if ING is calling for three cuts both from the Fed and the European Central Bank, why does EUR/USD need to go anywhere? We would reply that a synchronised easing cycle premised on a soft landing – not a crisis – is positive for a pro-cyclical currency such as the euro. At 1.10, our forecast for EUR/USD upside is not particularly aggressive anyway and only represents a mild deviation from EUR/USD medium-term fair value, which we have at 1.08.

BoJ's FX intervention and USD/JPY



Source: Bank of Japan, ING

What to make of BoJ FX intervention?

Many economists were quick to rail against Japan's use of FX intervention to try and slow the yen's decline. The argument goes that FX intervention will always be dwarfed by global capital flows and even at $62bn in May, the intervention will prove ineffective.

We agree that FX intervention alone is unlikely to turn the trend in USD/JPY. At least a Bank of Japan tightening cycle is more consistent with the BoJ's efforts to drain yen liquidity and support the yen.

However, what may be more telling from Japan's intervention is what Tokyo thinks about Fed policy and US rates. Tokyo had a good call with its $70bn of FX intervention in September and October 2022, before US rates softened and USD/JPY corrected 15% lower. And notably, the yen was one of the strongest performers again in the last two months of 2023 when US rates turned lower.

Given the yen is one of the most undervalued currencies based on our models – plus our house call for lower US rates this year – we think Japanese authorities may again be timing their intervention to catch the top in the cycle. We remain happy with a USD/JPY target near 140 later this year – a move that will be supported should US election risk spark higher market volatility.

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