Chris Turner: Sticky US inflation is the biggest threat to our FX views

Our baseline FX view sees the Fed easing cycle kicking off a multi-year dollar bear trend later this year. That should be good news for global growth in that a weaker dollar can export lower US rates around the world. The biggest threat to this view comes from sticky US inflation keeping the US yield curve inverted and the dollar stronger for longer

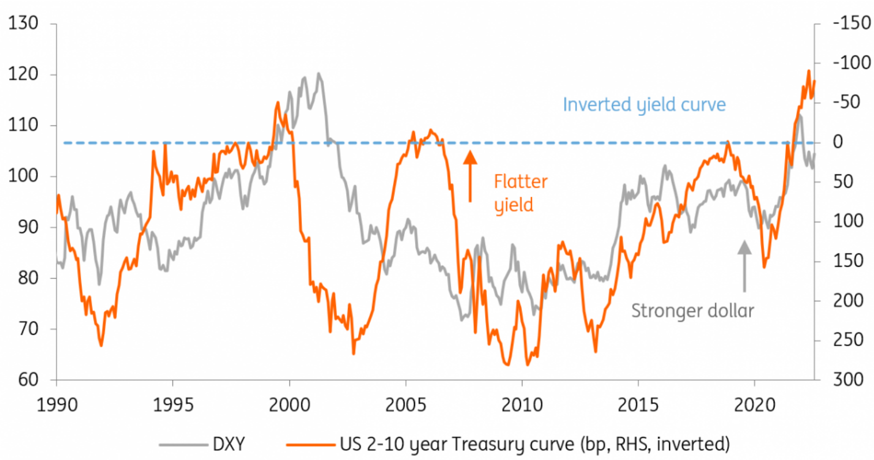
Being bearish on the dollar is our baseline view

Our baseline view in FX markets is that the dollar over the coming months will be entering a cyclical bear trend. This is premised on tighter US credit conditions adding to tighter monetary conditions and delivering the long-awaited US disinflation story. Should the Federal Reserve be in a position to cut rates sharply later this year, we are convinced that the dollar would trade lower. Under that scenario, we think EUR/USD should be somewhere in the 1.15+ area by year-end, while USD/JPY should be below 130.

Our cyclical call for a weaker dollar later this year should be roughly in sync with the next chapter of the US business cycle, where the bearish inversion of the US Treasury curve rotates into bullish steepening - all premised on the Fed being able to respond to the slowdown with rate cuts.

Equally, a weaker dollar should be a positive story for global growth. Many countries, especially emerging market countries, have had to support local currencies with higher rates. A turn in the broad dollar trend should give them some breathing room and perhaps attract to emerging markets the kind of positive portfolio inflows not seen since late 2020.

Cyclical dollar bear trend premised on a steepening of the US yield curve



Source: Refinitiv, ING

The alternative is a 1980s style dollar rally

As above, US disinflation is the vital cog in the wheel to a weaker dollar. Failure of US inflation to slow would keep Fed policy tight/tighter for longer - probably causing a deeper US slowdown if not a recession. Under such a scenario, the US yield curve would stay inverted for a lot longer, and 5-6% dollar interest rates would look even more attractive amid a global slowdown. Such a scenario would loosely resemble that of the early 1980s when Fed Chair Paul Volcker took the US economy into recession in order to get inflation under control. The hugely inverted US yield curve at that time sent the dollar through the roof and added to the US current account deficit. That dollar rally was only reversed in 1985 when the G5 nations agreed on the need for an orderly reversal of the dollar with the Plaza Accord.

Equally, the Fed keeping rates tight/tighter for longer would exacerbate the global slowdown and exacerbate the decline in pro-cyclical currencies such as the euro. In addition, many emerging market economies looking for breathing room with a weaker dollar would be frustrated. And presumably higher dollar rates would tip more EM sovereigns into default/debt restructuring. Instead of the virtuous cycle of a weaker dollar and lower global rates, the cycle could become a vicious one.

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