FX: The dollar bear trend has only just begun

US fiscal policy paralysis and a change in monetary policy strategy from the Federal Reserve make the case for the dollar bear trend extending well into next year. We revise up our end 2021 EUR/USD forecast to 1.25

Source: Shutterstock

Negative real yields drive the dollar

If real interest rates are one of the best gauges of monetary policy settings then US monetary conditions are now the loosest they have been since 2012. These loose conditions have led to accusations that the dollar is being deliberately 'de-based'. That term seems a little too pejorative, but what is clear is that the Fed has its foot firmly on the reflationary accelerator and a weaker dollar is part of the preferred monetary policy mix at this early stage in the recovery cycle.

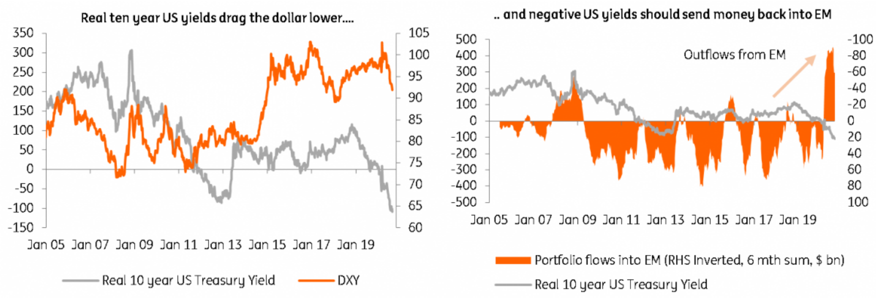
Below, two charts highlight the impact of negative US real yields on i) the dollar and ii) portfolio flows into emerging markets. Arguably, the DXY should have traded weaker into 2012/2013 on the back of the decline in US real yields. Yet that period marked the height of eurozone debt tensions. What is different now is a period of relative calm in European politics – presenting an opportunity for the EUR/USD rally to extend into 2021 as the Fed keeps rates lower for longer.

We see the dollar downtrend extending through 2021

Equally, the trend towards more negative US yields has typically created a positive environment for portfolio flows into emerging markets. This year's exodus of capital from EM has been far more aggressive than that seen during the 08/09 financial crisis. And if global policymakers can keep 'V'-shaped hopes alive and second wave fears in check, we expect that the return of capital into EM will be a story that runs deep into 2021 – adding to the benign downtrend in the dollar.

For the above reasons, we see the dollar downtrend extending through 2021 and raise our end year 2021 EUR/USD forecast to 1.25 from 1.10 previously.

Negative real US yields hit the dollar and send portfolio flows back to EM



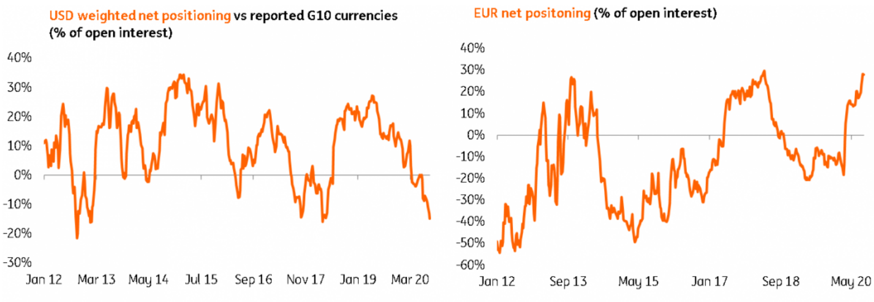
Source: Bloomberg, ING

Positioning and US elections muddy the water into year-end 2020

The reason we are not raising our 1.20 year-end 2020 forecast is largely on the back of a speculative market already heavily on board with these themes. Net dollar positioning is as short – and EUR positioning as long – as it was in March 2018.

Heavy one-way positioning normally warns of a correction. Yet the febrile atmosphere running up to the November elections and the prospect of a contested election result warns that a risk premium could be built into US asset markets. It would be a rare occurrence, but a 'sell US' investment thesis may well emerge and trigger a rare period of positive correlation between the dollar and US equity markets. USD/JPY could be pressing the 100 level in such an environment.

Positioning: Speculators are very short USD... and long EUR



Source: CFTC, ING

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com