The dollar: New year, new rules

If there's one currency suffering from a bout of January Blues, it's the US dollar

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Why we're still bearish on the dollar

There are a multitude of factors for our broadly bearish dollar view – the ambiguous economic and repatriation effects of the GOP Tax Bill, an unsettled US political backdrop ahead of the November midterm elections and the better goldilocks investment opportunities outside of the US. The latter two factors, in particular, is seeing the USD lose its role as an investment currency and trading under new rules where an environment of rising US rates no longer guarantees USD strength. Greater synchronicity across bond markets, amid a broadening global recovery, is one factor we've touted before. But we also see the Fed as a negligible factor for the USD in 2018 – not least because of the internal dichotomy of views over the key issues related to the long-run US economic outlook. This 'Fed confusion premium' – which will be clear in the latest FOMC minutes set for release today – may keep short-term US rates and the US dollar at bay throughout January.

EUR: Bullish momentum may briefly halt but EUR/$ at 1.25 is a matter of time

The EUR has started the new year pretty much where it left off – on the up and not shy of any positive catalysts. This is certainly the case when considering the backdrop of thriving economic activity and above-potential eurozone growth, renewed sentiment over deeper European integration and the markets' underestimation of the pace and extent of future ECB policy normalisation. These positive factors underpin our view for EUR/USD to move up to 1.25 in 2Q18. However, ahead of this, we do look for stability – not least because of a realisation that a sharp rally beyond 1.25 in 1Q18 would test the ECB's 'pain threshold' and elicit a relatively dovish reaction from the central bank. A reality check on EZ inflation data and Italian elections may implicitly help the ECB's cause by holding EUR bulls at bay in 1Q18. But EUR/USD making a charge towards 1.25 is merely a matter of time.

GBP: Looking for GBP/USD at 1.40 in 1Q18 as UK economic pessimism fades

"Less Noise, More Poise" is our motto for GBP in 2018 and its resilience in recent weeks somewhat encapsulates this sentiment. While progress during Phase II of Brexit negotiations – and subsequent clarity over the UK's new macroeconomic paradigm – will be the overarching theme dominating GBP's direction of travel in 2018, we see two factors dictating the pound's narrative in the short-term:

(1) Domestic UK politics and

(2) The Bank of England's policy path.

On the former, we believe noise around a fragile Conservative government may act as a limiting factor for the currency – but note that the bar to actively sell the pound on UK politics remains high. This has been evident in GBP positioning data; while speculative investors have turned net long in recent months, this adjustment in positioning has been mainly driven by GBP shorts bailing – which suggests to us that the attractiveness of selling GBP has been fading given the absence of any factor that could seriously delay Brexit talks and push the UK closer towards the March 2019 cliff-edge.

In terms of UK politics, only a 2018 General Election may feasibly see such risks being priced into GBP. This is not our base case scenario. Instead, we prefer to focus on potential catalysts for a positive reassessment of the UK economic cycle and a hawkish re-pricing of BoE policy expectations. We cite two non-mutually exclusive factors – an agreed Brexit transition deal by 1Q18 and positive surprises in UK economic data. Some combination of these factors could bring into play a 1H18 BoE rate hike (likely May). Our conviction call is for GBP/USD to rally up to 1.40 on this story, with EUR/GBP moving to 0.85-0.86.