

3 calls for FX as the dollar stays strong

We're expecting a strong dollar, high volatility, and more central bank intervention in the second half of this year



1 Dollar to stay strong

FX traders talk of a dollar 'smile curve'. This is the idea that the dollar strengthens when things are either very good or very bad. And conditions in between would typically see a benign dollar decline. The second half of this year certainly tends to favour events at the extreme end of the smile curve and the dollar staying supported. At one extreme, US growth can hold up such that the Fed can push ahead with tightening, taking the overnight USD rate above 3%. That's a high rate for the world's most liquid reserve currency. The alternative is that the US and world economies cannot simply stomach these fast tightening cycles. Here equities correct lower still, perhaps in a disorderly manner. This extreme risk-off environment would see a flight to safety into the dollar even if the Fed tightening cycle were to be cut short. Energy independence stands the dollar in good stead too.

2 Volatility to stay high

FX volatility is high and is expected to remain so for large parts of the second half of the year. Driving this surge has undoubtedly been the sharp adjustment in interest rate volatility as central banks, in many cases belatedly, respond to the toughest inflation environment in 40 years. Tighter levels of liquidity as central banks tighten policy rates and shrink balance sheets also support larger realised moves in FX rates, as do the latter stages of business cycles. Having at times been under 6% over the last 15 years, EUR/USD implied volatility is now closing in on 10%. We expect these higher levels of FX volatility to be maintained or increased even further in 2H22 meaning

that we all need to be prepared for bigger swings in spot FX rates.

3 Central banks to intervene more

The second half of 2022 should see even more FX intervention from central bankers. We would split this activity into two: defensive and offensive. On the defensive side, many emerging market central banks have been trying to resist local currency weakness through FX intervention. We can think of quite a few central banks in Asia, Latin America and the EMEA region undertaking this activity with various levels of success and various levels of FX reserve adequacy. Expect the stronger dollar to demand more action from this community and greater scrutiny of FX reserve sales and their implications for US Treasuries. The Bank of Japan looks likely to join this defensive camp in 2H22 when USD/JPY pushes above 140. Into the offensive camp go the likes of the Swiss National Bank and Czech National Bank, which are selling FX to drive local currencies higher and tighten monetary conditions. More central bank FX intervention will also maintain higher FX volatility levels.

Author

Chris Turner

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

chris.turner@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.