Tin hat time in FX markets

Continued pressure in global equity markets sees an on-going flight to safety in the FX world. What's different this time is that the market may be starting to price in a fresh round of QE from the US Federal Reserve, which is a clear dollar negative

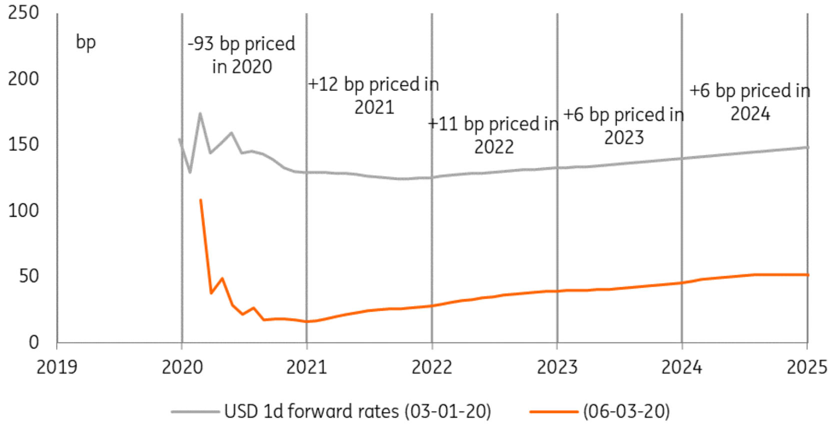
Currency traders in South Korea

Market moves to price a Fed Funds rate at 0.25%

Continued pressure in global equities sees investors rotate into safe-haven assets, particularly in high-quality sovereign bonds, and price an aggressive policy response from central bankers with room to cut.

As you can see in the chart below, our Rates Strategy team highlights how the market has shifted to price the Fed Funds rate at 0.20% later this year – effectively the zero lower bound. Markets are now asking what next from the Fed? Another QE programme? Certainly, the Federal Reserve has room on its balance sheet to resume QE should it so choose, given that its balance sheet is now just 19% of GDP versus the 26% peak in 2014.

Markets shift to pricing the Fed Funds rate at 0.20% within six months



Source: ING Rates Strategy Team

Fed QE would be a game changer for the dollar

QE programmes have been some of the biggest drivers in FX regime shifts over the last decade. The Fed enjoyed first-mover advantage in 2009, with their initial programmes sending EUR/$ to 1.50. As conviction grew of the ECB belatedly starting a QE programme, EUR/$ fell 20 cents in 2014.

The spread of Covid-19, its economic impact and the policy response remain highly uncertain, but it seems as though the FX markets are starting to price in the Fed's money printing presses being properly fired up again.

If the Fed were to restart QE, we would expect the dollar to undertake a much deeper decline than the one we currently pencil in (e.g. EUR/$ to 1.15 in 2Q20). This would really be the US monetary story converging on the zero rates and QE underway among major trading partners.

ECB and BoJ would struggle to resist EUR and JPY strength

In an environment where the Fed re-starts QE, the White House would elevate its Currency Manipulation framework – expecting other trading partners to allow the dollar to adjust to the new environment. This goes to the heart of the US currency manipulation debate – namely that over previous decades trading partners of the US have not allowed their currencies to fully appreciate as part of an orderly adjustment of global imbalances.

> *This makes currency intervention to limit local currency strength very difficult indeed*

This makes currency intervention to limit local currency strength very difficult indeed. Historically known for their FX intervention, Japanese authorities are unlikely to undertake intervention in USD/JPY before 100. Instead, the expectation is that the semi-official sector, e.g. GPIF, would see good value in $/JPY at 105 to increase US Treasury purchases. But 105 would remain under heavy pressure were the Fed to consider QE.

Switzerland has recently been elevated to Washington's currency manipulation Monitoring List and will find it hard to undertake the typical amounts of FX buying seen through prior crises. USD/CHF could, therefore, be embarking on something much more than a trip to 0.91/92.

And for EUR/USD. The ECB cannot match the Fed in terms of rate cuts, nor does it appear to have the appetite for dramatically increasing its APP programmes. Today's move in EUR/$ suggests investors are just starting to consider this outcome. EUR/$ is well on the way towards our target in 2Q20. But were the Fed to be called into more drastic action – e.g. starting with a 50bp rate cut at the March 18th meeting and bringing QE a little nearer – then the temporary EUR/USD rally we see could be longer and draw in a discussion of 1.20.

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 www.ing.com.