More bad news for US dollar bears?

Is the dollar short squeeze set to continue? An event-filled US economic calendar in the week ahead may provide clues

USD: Another tough week for dollar bears

US economic divergence or Rest of World economic convergence is now the number one dilemma facing investors – especially given that global asset price dynamics in the coming months will broadly hinge on which of these two narratives prevail. Should it be the former, which we still remain unconvinced over, the risk in the FX universe is that the current short US dollar squeeze turns into a more enduring fundamental rally. The event-filled US calendar in the week ahead will provide further evidence over which way the US-RoW economic pendulum is swinging.

- **May FOMC meeting (Wed):** Bar acknowledging the weather-disrupted soft 1Q GDP print, strength in forward-looking activity indicators and the recent uptick in inflationary pressures – which seem to be evolving in line with expectations – we doubt that the May FOMC statement deviates much from the status quo. A hawkish surprise would be if the statement alluded to a “faster pace of tightening than previously anticipated”; this would be highly out of character for an inherently risk-averse Fed – while if it were to happen, it may just be an endorsement for the markets’ growing expectations of four 2018 hikes. Given the flatness of the US yield curve, policy communications may at this stage require the delicacy that a press-briefing meeting (ie, June) allows for.

- **US data:** Despite a string of activity data releases in the form of ISM and NFP, the standout data release this week will be core PCE inflation (today) - which is set to jump to 2.0% year-on-year (from 1.6% YoY). We will be intrigued to see if there is any major fallout in the bond market given that this is partly due to annual base effects; but if there's any excuse for the US 10-year yield to materially clear the 3% handle, then a US inflation 'reality check' is a pretty good one.

- **US Treasury's quarterly refunding announcement (Wed):** Talking of the bond market – with fiscal stimulus needs and the Fed's unwinding of QE set to peak in 2H18, there is a big focus on how the Treasury will meet its rising financing needs over the next few years. The rise in short-dated yields and their impact on hedging costs are helping to drive the short dollar squeeze – and greater T-bill issuance may fuel this story in the near-term. Equally, increased auction sizes do place greater reliance on the 'kindness of strangers' to fund the US deficit.

- **Geopolitics:** On that note, US trade policy will be back in focus this week – as the previously placed exemptions on steel and aluminium producers are due to expire tomorrow (May 1). While the NAFTA countries look to be granted an extension, the question is whether the EU will join China on Trump's 'naughty trade list'. This trade war escalation may keep risk appetite on the back foot.

For now, it still feels like markets have adopted the mantra of "let's clear out and start again" – meaning US dollar bears may have further pain to endure this week.

EUR: 1.20 level will be crucial in determining broader FX market sentiment

From the Eurozone side, the highlight will be the 1Q18 GDP data release (Wed). Most expect a slowdown to a pace of 0.4% quarter-on-quarter, but arguably this is now priced into euro rates and FX markets. In the same way that the 3% US 10-year yield was a big story in the bond market last week, 1.20 should be almost as important for the FX market this week – especially with the 200-day moving average at 1.2010. Solid US data will test this. Please see G10 FX Week Ahead: A Fresh Start, for all our FX views.

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