Dollar succumbs to the blue ripple

A divided US Congress has some important implications for the dollar going forward

USD: More a blue ripple than a blue wave

US mid-term elections have evolved largely as the pollsters predicted, with the Republicans taking the Senate and the Democrats looking likely to take the House – albeit by a margin less than predicted. While it is tempting to say that this result was already priced in, we do think a divided Congress does have some important implications for the dollar going forward. The vastly reduced chances of fresh US fiscal stimulus will re-emphasise the US as a late-cycle economy heading into 2019 (along with a flat or even inverted curve) and suggests to us the dollar will top out in the 3-6 month window rather than a 6-18 month window, which would have been the case on a fresh tax cut. Additionally, the loss of the fiscal stimulus option will probably see greater incentive in Washington to talk the dollar lower – either indirectly through pressure on the Fed or perhaps more direct references to FX. For the short term, today's dollar reaction delivered on the +/- 70 USD pips priced into EUR/USD FX options market, but we suspect we could see some further modest dollar declines – more against high yield than G3. We prefer the high yielders because after Thursday's FOMC, the market will turn its attention to the prospects of a US-China trade deal at the end of this month. EUR funded carry trades could become popular this month. The US dollar index to trade 95.50-96.50.

EUR: A muted reaction so far

EUR/USD has nudged higher, but there has certainly been no dramatic re-assessment of the factors that have sent it under 1.15. ING's base case on the Fed was four more Fed hikes on the assumption of no fresh US fiscal stimulus and it looks as though the tremendously expensive USD hedging costs (now 815 USD pips on the two year EUR/USD forward) may only increase. For today, we've seen a modest pick-up in German IP but Italian politics (a confidence vote in the Senate tomorrow) will keep enthusiasm in check. We suspect EUR/USD can edge up to 1.1500, but favour EUR underperformance on crosses.

GBP: Rate markets unwind October's 'no-deal' decline

GBP one-month OIS, priced two years forward, declined 30 basis points in October as fears of a 'no-deal' Brexit grew. This month, they've reclaimed 17 basis points of that decline and could rise further if the recent urgency/optimism in discussions continues. We're looking for EUR/GBP to break 0.8720 and trade to the year's low at 0.8620.

ZAR: Bear market bounce

USD/ZAR is threatening to break key support levels at 14.00. A slightly softer dollar and (temporary) prospects of an easing in US-China trade tensions ahead of the Trump-Xi meeting at the end of this month could see high yield/emerging markets enjoy a temporary bounce. Favour EUR/ZAR to 15.70, maybe 15.30.

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