USD: A different kind of decline

After a decent run for the dollar in 2019, many are now calling for broad-based depreciation. But we think things are a little more nuanced

Source: Shutterstock

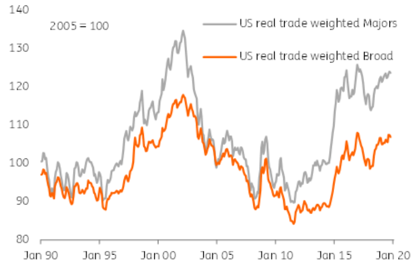
- The end of US exceptionalism is sparking calls for a weaker dollar into 2020. We think the dollar decline will be far more differentiated than broad-based
- Most US Presidential candidates favour a weaker dollar. The best way to achieve that is to improve trade relations and create attractive alternatives overseas.
- Russia and China are making steps to de-dollarise their economies. Progress has been slow and the dollar is still by far the most favoured transaction currency.

A good year but will it last?

2019 has generally been a good year for the dollar. Marginal new highs have been seen in the rally that started in February 2018 – when the White House fired the opening salvos in the trade war. The dollar rally has largely been concentrated against pro-cyclical currencies with the occasional exceptions in G10 (Canadian dollar, British pound) and in emerging markets (rouble, Thai baht).

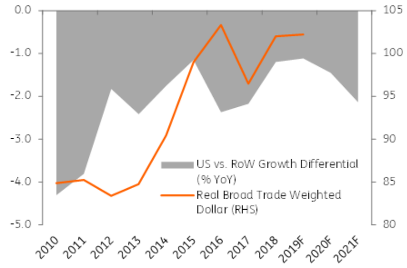
A common expectation for 2020 now seems to be one of broad dollar depreciation. Fund managers are most bearish on the dollar since September 2007 and the familiar narrative is that the end of US exceptionalism spells trouble for the dollar. Certainly, we subscribe to the view that the US growth differential against the Rest of the World (RoW) will shift against the US over the next couple of years.

Fig 17 Dollar has nudged higher this year...



Source: Bloomberg

Fig 18 ...but RoW may start outperforming US in 2020/21



Source: Macrobond, ING

Rest of World to underwhelm

The difference is that we expect the growth performance in the RoW to be far from uniform. Most importantly, 2020 will not be a repeat of 2017 when the world economy was firing on all cylinders (even Europe participated). Back then, synchronised global growth saw trade volumes growing 5% year-on-year and the dollar embarking on a broad decline.

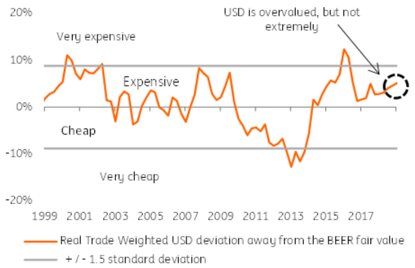
Given our view that Europe will not be a particularly attractive investment destination in 2020 and that the popular DXY is 77% weighted towards European currencies, we are not looking for a major DXY decline next year.

Based on our view of only modest upside for EUR/USD (1.13 end-2020) we expect DXY to fall just over 2% next year. If EUR/USD is closer to 1.10 rather than 1.13 at the end of 2020, then that DXY decline is under 1%.

We also take issue with some views that the dollar is materially overvalued. Our medium-term fair value measures have it nowhere near as overvalued as it was in early 2017, largely because we have seen a fall in EUR and GBP fair values versus the USD.

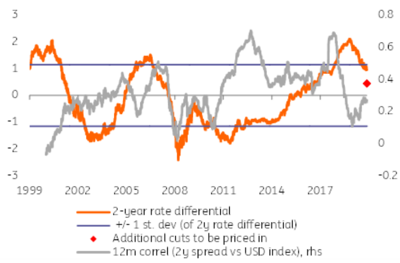
In addition, we think that the Federal Reserve has to deliver at least three to four independent cuts (relative to other central banks and in addition to the Fed rate cuts already priced in) to bring rate differentials back into a range that makes a difference for dollar pricing – see Figure 20 . One of the core stories in 2019 has been that, despite three Fed rate cuts, dollar hedging costs have still been too expensive to make a difference. For example, the costs for European investors to hedge USD exposure have fallen 100 basis points this year, but, at 2.5% per annum, they are still too high in a low yield world.

Fig 19 The dollar is not particularly overvalued



Source: ING

Fig 20 Dollar differentials need to narrow a lot further



Source: ING

The yield story is probably more important than we think. Looking at the portfolio flow story, both ECB and US Treasury data suggests hot money – or short-term financial flows - could be driving exchange rates. For example, we talk about US exceptionalism and the US sucking in capital, but data does not bear this story out.

Through the 12 months to September 2019, foreigners bought only a net US$41 billion of US securities (Treasuries, corporate bonds and equities) versus US$334 billion in the 12 months to September 2018. Instead then we believe short-term financial flows are driving dollar strength. Unless the Fed cuts very aggressively in 2020 (eg, three or more times) we do not see a stampede out of USD deposits.

Trump and trade

When it comes to Washington's FX policy, it is fair to describe this as mercantilist. The White House occasionally rails against the strong dollar, but its biggest bug-bears are the cheap currencies of China and Europe that have contributed to the huge US trade deficit. Should a Phase One Deal with China be signed, look out for any currency clause.

Such a clause may mirror the one suggested in the US-Mexico-Canada deal, which effectively backs a free-float and transparency on FX intervention. In theory this would prevent massive FX intervention from the Chinese to support USD/CNY should the dollar trend turn lower. Interference with an orderly Balance of Payment adjustment is Washington's concern.

We doubt that President Trump would turn to physical FX intervention to weaken the dollar – though he does have the authority. And occasional bills in Congress to effectively tax short-term capital inflows are unlikely to gain much cross-party support – where capital flow measures are more frequently associated with emerging economies.

Given the White House's increased use of sanctions over recent years, there will also be increasing focus on the topic of de-dollarisation. Pricing trade in currencies other than the dollar has long been a desire for strategic rivals of the US – a desire more recently compounded by the long reach of the US Treasury when it comes to sanctions.

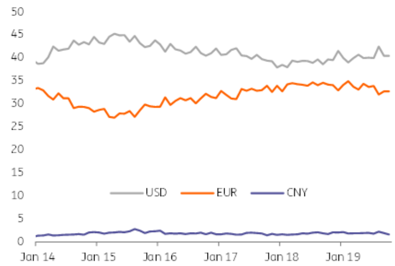
For example, China has for many years tried to encourage the use of the renminbi in international trade by signing Chinese yuan swap agreements with trading partners. Since 2008, China has signed up 33 countries to CNY swap lines – in an effort to encourage buyers of China's goods to have confidence to take on CNY payables.

Equally, Russia has made great efforts to de-dollarise its economy since 2013. Our Chief Economist in Russia, Dmitry Dolgin, recently released a detailed report on the subject. And the European Commission has a stated aim of strengthening the international role of the euro. For example, why does Europe still pay for its energy imports in dollars?

Despite these initiatives, so far there has been very little erosion in the dollar's dominance. In terms of trade flows tracked by SWIFT, the dollar comprises a consistent 40% in world trade flows. The CNY remains around the world's fifth/sixth most used currency in terms of trade flows – but consistently under 2%.

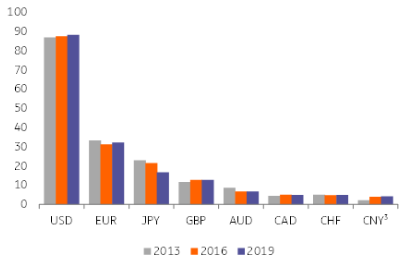
No doubt the mismanaged People's Bank of China fixing adjustment in 2015 and then the tightening rather than loosening of Chinese capital controls during the current trade war have not helped the internationalisation of the CNY.

Fig 21 FX share in global SWIFT payments (%)



Source: Bloomberg, SWIFT

Fig 22 Share in Global OTC FX turnover (%)



Source: BIS

2020 decline will be differentiated

Looking more broadly at both trade and financial flows, the BIS triennial FX turnover survey shows no change in the position of dollar hegemony. Higher US rates have probably helped and so far there is absolutely no sign of investors demanding a risk premium in US assets. Despite fears of President Trump generating unsustainable twin deficits with the 2018 tax cut, the US sovereign five-year CDS still trades at a mere 15 basis points. On balance then we think the 2020 dollar decline will be a lot more differentiated. Rather than a broad-based move, we look for pockets of selective weakness against emerging market currencies (Latam and Asia rather than Europe) and a few of the undervalued commodity currencies in the G10 space.

This article is part of our 2020 FX outlook report.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
DXY	98.30	98.00	98.00	97.50	96.50	95.50

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