USD: The wrong kind of rally

Thursday is turning into one of the darkest days of market dislocation since the Global Financial Crisis in 2008/09. The ECB package has failed to calm nerves (quite the opposite in fact) and market pricing suggests USD funding could be a problem again. Risk assets look set to stay under pressure, but QE from the Fed could turn the dollar around into next week

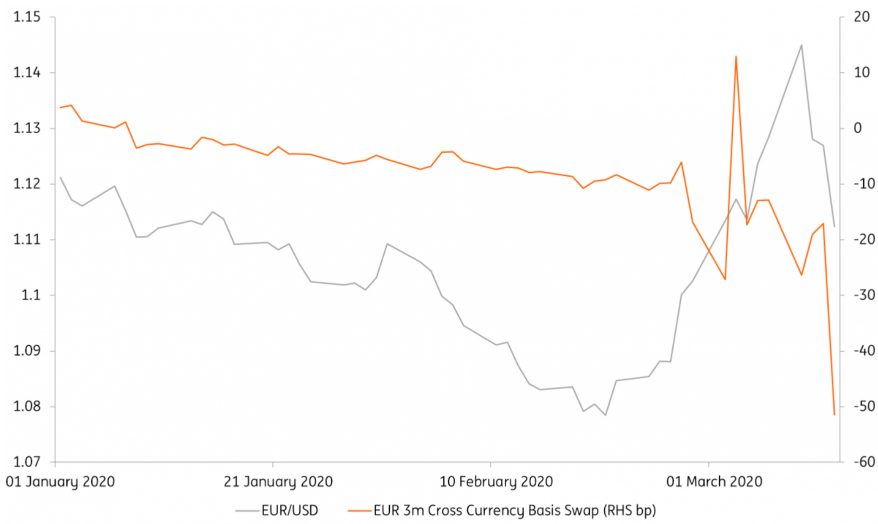
Cross currency basis swap recalls events in 2008/09

Global financial markets are reeling. One day losses in excess of 10% in some major equity benchmarks recall the dark days of October 2008. We have also been keeping a close watch on money markets. As Padhraic Garvey noted earlier this week, money markets have started to show signs of stress.

What stands out for us today is the widening of the EUR cross-currency basis swap. Recall this represents (when it is negative) how much banks are prepared to lend out EUR below inter-bank Euribor rates to get hold of USD funding through the FX swap market. Back in 2008, this swap had blown out to levels in excess of -150 basis points as European banks, shut out of USD wholesale funding markets, scrambled to the FX swap market to fund their USD loan book.

Today's dramatic widening in the cross-currency swap suggests all is not well with the USD funding market. Indeed, the Federal Reserve's 14-day and 25-day repo operations were over-subscribed and represent an unfilled demand for USD funding. The Fed will be monitoring these developments carefully and will be speaking with banks as to the best measures to address it – e.g. much larger and longer-term USD repo operations. Or more likely, as the guardian of the world's financial system, the Fed will be looking at a permanent liquidity add by re-starting quantitative easing. Here, the Fed shrank its balance sheet last year (President Trump called it 'quantitative tightening') and has plenty of room to grow it back to the peak of 25% of GDP from levels near 19% today.

Cross currency swap blows out, representing squeeze in USD funding



Source: Bloomberg, ING

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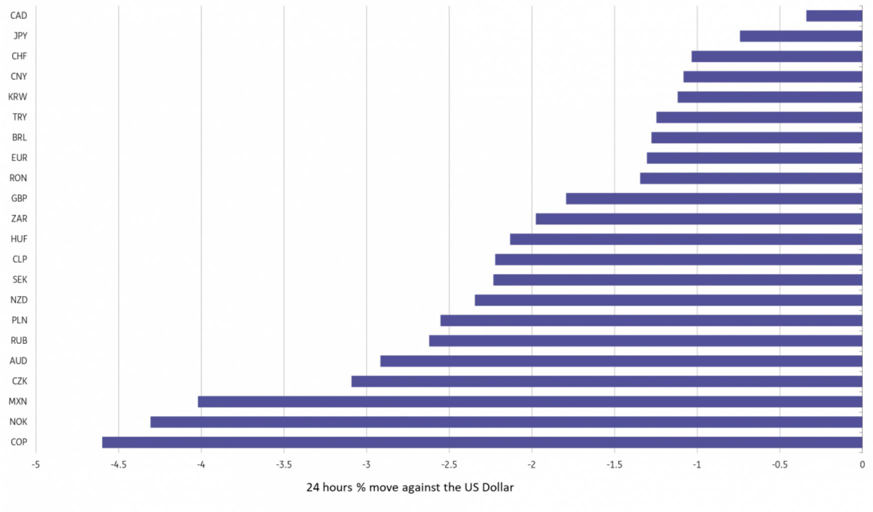
Today's move by the European Central Bank has not helped confidence in risk assets at all, but it would be wrong to think the dollar outperformance today represents some kind of global re-assessment of risks, favouring the US. Far from it. Typically these types of moves in money markets come during periods of extreme stress, where the unwind of a long term, benign environment for equities has painful consequences.

Given the piecemeal response from most (ex UK) politicians and now the ECB effectively saying 'we're done here', we expect risk assets to stay under heavy pressure and volatility levels to stay through the roof.

However, today's developments do bring a more aggressive Fed response that much nearer. Assuming the Fed finds the right tools to address current dislocation, we expect the dollar to be reversing lower ahead of next week's FOMC meeting. That means the USD/JPY rally does not look sustainable above 105 and even today's crash in EUR/USD can find some support – perhaps around the 1.1000/1050 now.

For the rest of the FX market, we are still in a massive unwind stage with very little confidence (e.g. even the Czech koruna is getting hit hard). Expect commodity and high yield FX to remain under heavy pressure, while in the emerging markets space, we are particularly worried about those twin deficit countries with large external financing needs, such as India and South Africa.

Dollar goes bid across the board on Thursday



Source: Bloomberg, ING

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