

USD: Wake up and smell the (bearish) coffee

The continuing rally in commodity currencies and a generally weaker dollar across the board could still feel like a short squeeze in those accounts positioned for recession. But the options markets suggest a larger dollar decline may be brewing



More than just a short squeeze?

The latest CFTC positioning data for the week until 26 May suggests that despite AUD, NZD, and CAD currencies already having rallied to USD/0.6630, USD/0.6200, and 1.3775/USD respectively in the reporting week, speculative accounts were still running large short positions. The chart below shows that net short positioning in these currencies was still sitting at the lower one standard deviation band of the five-year range.

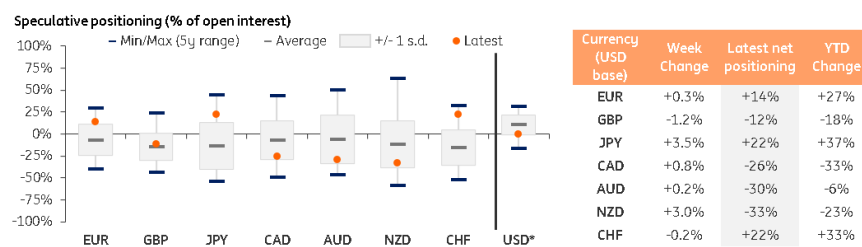
There are signs that the dollar bear trend is becoming more broad-based

One could then attribute the recent rally in commodity FX (2%+ over the last two weeks) merely to

a short squeeze triggered by a further turn around in the oil story and perhaps, more importantly, a sense that, as a continent, Europe will contribute to the global rebound (as it did in 2017) rather than be a drag.

But as we [discussed last week](#), there are signs that the dollar bear trend is becoming more broad-based and that even EUR/USD, where the speculative market is already substantially long EUR, is considering a top-side break-out.

Latest speculative positioning: Still short commodity FX



*Note: Aggregate USD positioning versus G10 FX. As of 26 May 2020 (data reported with a lag).

Source: ING, CFTC

Signs in the FX options market bear watching

There are some interesting signals emerging in the FX options market.

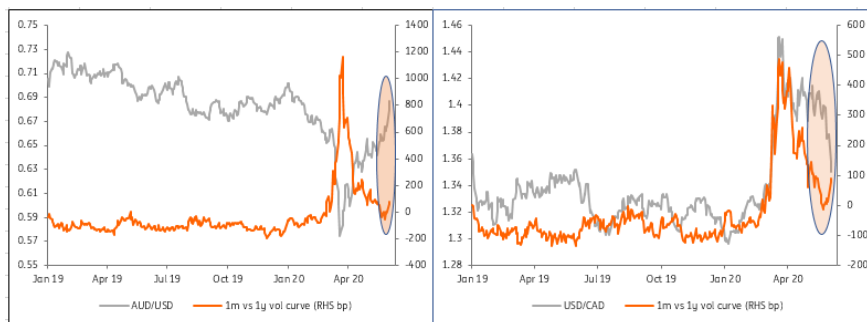
The shape of the traded volatility curves can provide some indication of the mood of the market. A gently sloping positive volatility curve shows effectively a term premium – or investors prepared to pay more for risk over the long term. Inverted curves are typically associated with risk-off episodes and shocks, where the market is prepared to pay up for short-term protection, fearing market dislocation.

Certainly, the events in March saw [enormous dislocation in FX markets](#), massively inverted volatility curves, and a stronger dollar as corporates rushed to hoard dollar cash after US commercial paper markets seized up. Equally, the subsequent calming in financial markets and a modest re-rating of global growth prospects after aggressive intervention from policymakers have started to see volatility curves normalise and the dollar weaken.

What interests us the most at the moment are developments over the last week. Here volatility curves have started to invert again – triggered by both buying of front end and selling of back end volatility – even as the dollar has continued to weaken.

We demonstrate this for the AUD/USD and USD/CAD markets below. This may be just a symptom of the short squeeze by leveraged accounts as the dollar weakens through big technical levels (e.g. the 0.6685 mid-March high in AUD/USD) or perhaps warning that a greater conviction is emerging that the dollar is ready to start on a more significant trend decline.

AUD/USD and USD/CAD and their one-month vs. one-year volatility curves



Source: Bloomberg, ING

EUR/USD: Let's watch the volatility curve too

These trends have not exactly been the case in the EUR/USD market.

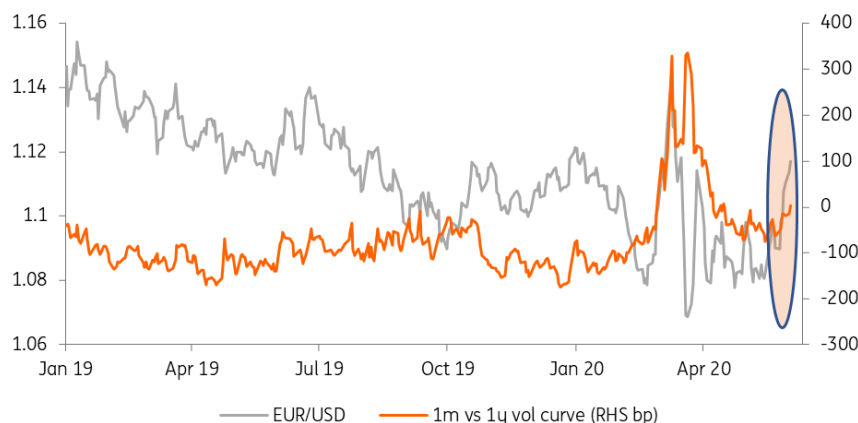
Yes, one-year traded volatility has fallen over the last week, but are yet to see a pick up in the 1-month volatility – which would probably represent the active buying of EUR calls/USD puts given that that one-month risk reversal skew has recently moved in favour of EUR calls.

Of course, these currencies (especially commodity FX) have come a long way already and substantial risks remain – most pressingly in US-China tensions and whether the White House administration rips up last year's trade deal.

But for the time being, the momentum is against the dollar and if EUR/USD starts to trade above the 1.1230/40 area on a sustained basis – especially backed by the buying of front end volatility – then EUR/USD could be embarking on a trend towards our year-end target of 1.20 earlier than we expected.

[Why we thought the dollar was overpriced](#)

EUR/USD and its one month vs. one year traded volatility curve



Source: Bloomberg, ING

Authors

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@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 <http://www.ing.com>.