

What a bearish re-steepening of the Treasury curve could mean for FX

The dollar continues to nudge lower as investors re-assess the Fed tightening cycle. Before the market rushes into 'risk on, dollar-off positions', we think US interest rates can actually rise over the coming months – particularly at the long end of the curve. So what would bearish re-steepening mean for FX markets?



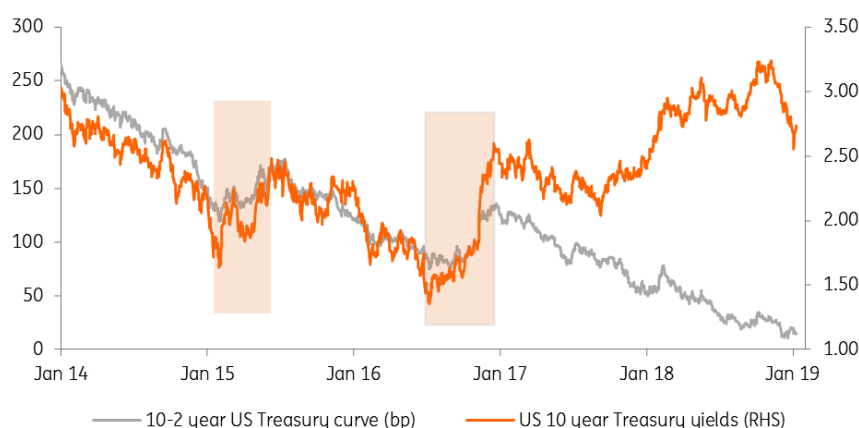
A brief period of re-steepening

2018 was all about the bearish flattening of the US Treasury curve and whether a move in the 2-10 year curve close to zero meant a US recession was imminent. After the sharp Trump/Fed/equity-led decline in US rates over the last two months of 2018, our interest rate strategy team now think the next major move in the US curve is a bearish re-steepening – perhaps by some 25bp.

Some modest thaw in US-China trade relations, perhaps even a chance of a second UK Brexit referendum or US data showing the economy isn't slowing sharply could all drive ten year Treasury yields higher. US price data could also do it, since the US 10-year term premium at -47 basis points remains incredibly low – especially since our macro team sees US core inflation heading into the 2.4/2.5% year on year area this summer.

The short end of the US curve looks far more anchored given the Fed's recently adopted stance of 'watching and waiting'. In this environment, our team sees the US 2-10 year Treasury curve re-steepening to the 35-40bp area from 15bp yesterday. What will all of this mean for FX?

Bearish re-steepening of US Treasury curve seen in 2015 and 2016



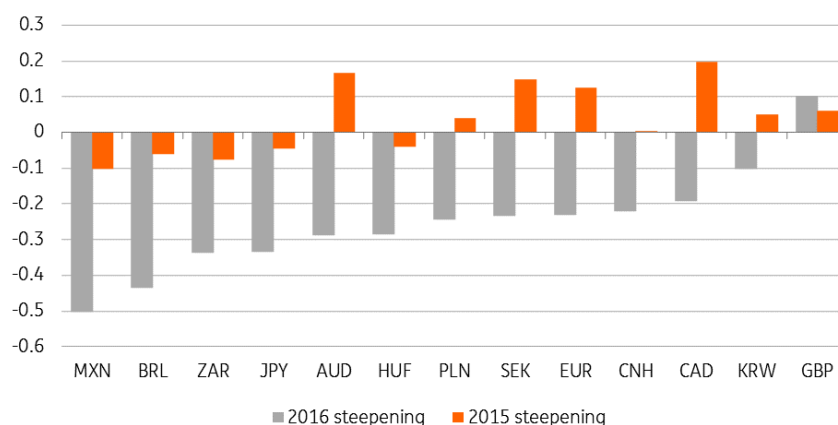
Source: ING, Bloomberg

How did FX perform during prior periods of Treasury curve steepening?

Since the flattening of the US yield curve since the start of 2014, we identify two periods of bearish steepening: i) early 2015 and ii) late 2016. The first coincided with a sharp recovery in oil prices and the second was President Trump's victory and the promise of reflationary policy.

The dollar was generally firmer during both of these periods, though with large variations per currency. In the chart below, we highlight the daily correlations between the changes in dollar pairs and daily changes in the 2-10 year US yield curve during the two periods. 2016 steepening saw consistent positive dollar correlations but 2015 was more mixed.

Correlation between currency per USD and US 10-2 year Treasury curve



Source: ING, Bloomberg

How will FX perform?

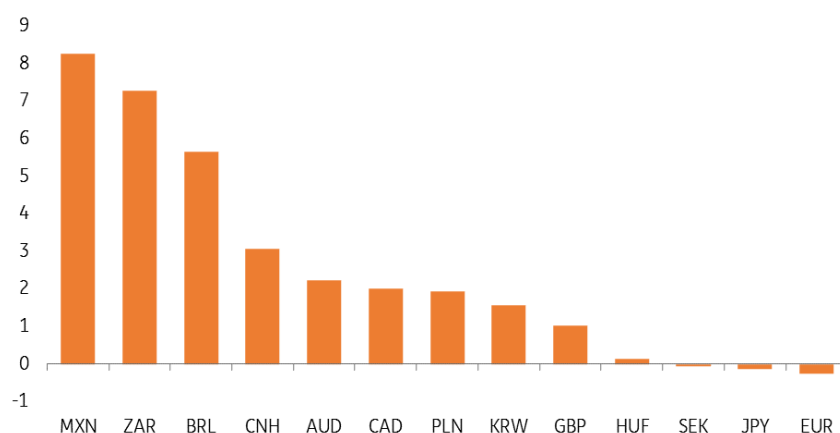
Historical correlations suggest a bearish re-steepening of the Treasury curve would see the dollar perform most consistently against the likes of MXN, BRL, ZAR and JPY. The problem for us is that investors are showing tentative signs of taking their money out of USD and putting it to work in emerging markets. We would also say that the MXN is a very expensive sell right now, with implied 3-month MXN yields at a huge 8.26%, which is not bad considering that inflation is running under 5%.

Instead, then we have greater confidence in a steeper yield curve driving USD/JPY higher (probably into the 110-112 area). And if: a) investors are putting money back to work in EM and b) Brent crude oil prices are heading back to the \$65/barrel as our commodities team believe – we actually think the MXN can perform quite well after all. From 5.63 currently, we see MXN/JPY trading back to the 5.85 area – helped by those very attractive yields and the Latam bloc's positive exposure to energy.

Despite yesterday's rally, we're not big fans of chasing EUR/USD a lot higher. There may indeed be a case for money to be put in emerging markets, which leaves the dollar lower across the board – but we'd certainly think the EUR would underperform any recovery in EM.

Implied 3-month yields across a range of currencies

(% per annum)



Source: ING

Author

Chris Turner

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

chris.turner@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>.