

## What war in the Middle East means for our FX forecasts

Sharply higher energy prices have seen the dollar rally broadly. European and Asian currencies in particular are likely to stay under pressure until energy markets calm down



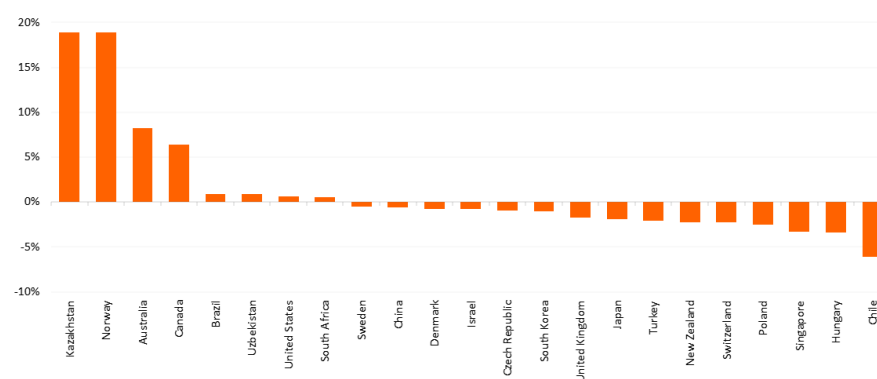
The dollar looks likely to remain stronger in the near term as the energy shock dominates

### Dollar gains a reprieve

After a soft opening to the start of the year, the dollar has come back bid. The surge in energy prices has been the key driver, which we think is driving dollar strength through three channels.

The first, as it was in 2022, is the direct impact higher energy prices have on external accounts. Investors recall how in 2022, the higher cost of energy imports saw the eurozone monthly trade account swing to a near €50bn deficit by the late summer. US energy independence is being rewarded, while the fossil fuel importers of Europe and Asia are punished.

## Fuel balance as a % of GDP during the last oil energy shock in 2022



Source: Macrobond, World Bank, ING

The re-pricing of the Federal Reserve cycle is the second key channel. 1m USD OIS rates priced one-year forward have quickly bounced 25bp since the start of the conflict. That not only makes dollar hedging costs more expensive, but a bearish flattening of the US yield curve is normally a dollar positive by what it means for growth prospects.

This leads us to the third channel of a stagflationary shock hitting a market positioned overweight Europe and emerging markets in anticipation of synchronised world growth. An unwind of these inflows, which had been building since last summer, is also buoying the dollar.

Back in 2022, we noticed that the shift in terms of trade (export versus import prices) was a key driver in raising the fundamental medium term value of the dollar. That is why making a call on the duration of this energy shock is so important. Our baseline of more settled energy markets by the end of the month should mean the dollar starts to hand back some of its recent gains. Meanwhile, a three-month plus shock would be another, more bullish dollar matter entirely.

### The forecasts

We are raising our dollar forecasts for the first half of the year on the view that energy prices will likely be higher than they were before the crisis and that the inflationary risk will delay – but not derail – the Fed easing cycle. That means EUR/USD could be ending March somewhere near 1.15/16. Assuming that conditions calm, eurozone growth comes in as planned and the Fed can cut rates twice in the second half, we then look for EUR/USD to still push up to the 1.22 area by year-end.

Asia is also at the forefront of this supply shock and USD/JPY looks to stay stronger for longer. Unilateral intervention from the Bank of Japan looks likely somewhere near 160. Co-ordinated intervention with the US looks a more complicated proposition, but cannot completely be ruled out after the Treasury requested that the Fed ‘check’ USD/JPY rates last month. Expect USD/JPY to trade towards the top end of a 155-160 range, while energy stays bid. But a calmer environment in the second half should still see USD/JPY end the year closer to 150.

In general, however, our prior baseline of a benign dollar decline this year will increasingly be challenged the longer this conflict continues.

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