



US dollar: Curb your enthusiasm

Key messages

- At the heart of the USD's 4% correction in 2018 is the question of whether US growth and interest rates are once again diverging away from the Rest of the World (RoW).
- We don't subscribe to this view – with the dollar move exhibiting classic signs of a counter-trend rally. Unlike 3Q17 though, heavier short USD positioning and thin market liquidity are likely contributing to the 'speed' of the current USD correction.
- We believe that market expectations are now reflecting peak short-term economic divergence, meaning that the USD does not need to rally much further from current levels in the absence of a more pronounced decline in the RoW economic outlook.
- Equally, rate spreads have had little correlation with EUR/USD up until late April. Even if going forward they were to dictate EUR/USD moves, we would at best see a low of 1.17-1.18 this summer – before a broader recovery to 1.30 by the end of the year.
- Plus it's far too early to dismiss the risk of further protectionist pressure on the USD – especially under a US administration which clearly desires a weaker currency.
- We modestly raise our USD forecasts for the summer, but remain convinced that by the end of the year – and into 2019 – structural forces will drive the dollar to levels weaker than where it currently trades today.



Chris Turner

Global Head of Strategy
London +44 20 7767 1610
chris.turner@ing.com



Petr Krpata, CFA

Chief EMEA FX and IR Strategist
London +44 20 7767 6561
petr.krpata@ing.com



Viraj Patel

Foreign Exchange Strategist
London +44 20 7767 6405
viraj.patel@ing.com

ING's revised forecasts for major currency pairs – May 2018

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EUR/USD	1.25	1.20	1.23	1.30	1.31	1.32	1.33	1.35
<i>Prior</i>	1.25	1.28	1.28	1.30	1.31	1.32	1.33	1.35
USD/JPY	107.0	108.0	106.0	105.0	103.0	102.0	100.0	100.0
<i>Prior</i>	107.0	105.0	103.0	100.0	100.0	100.0	100.0	100.0
GBP/USD	1.42	1.36	1.40	1.53	1.58*	1.61*	1.64*	1.69*
<i>Prior</i>	1.42	1.45	1.45	1.53	1.58	1.61	1.64	1.69

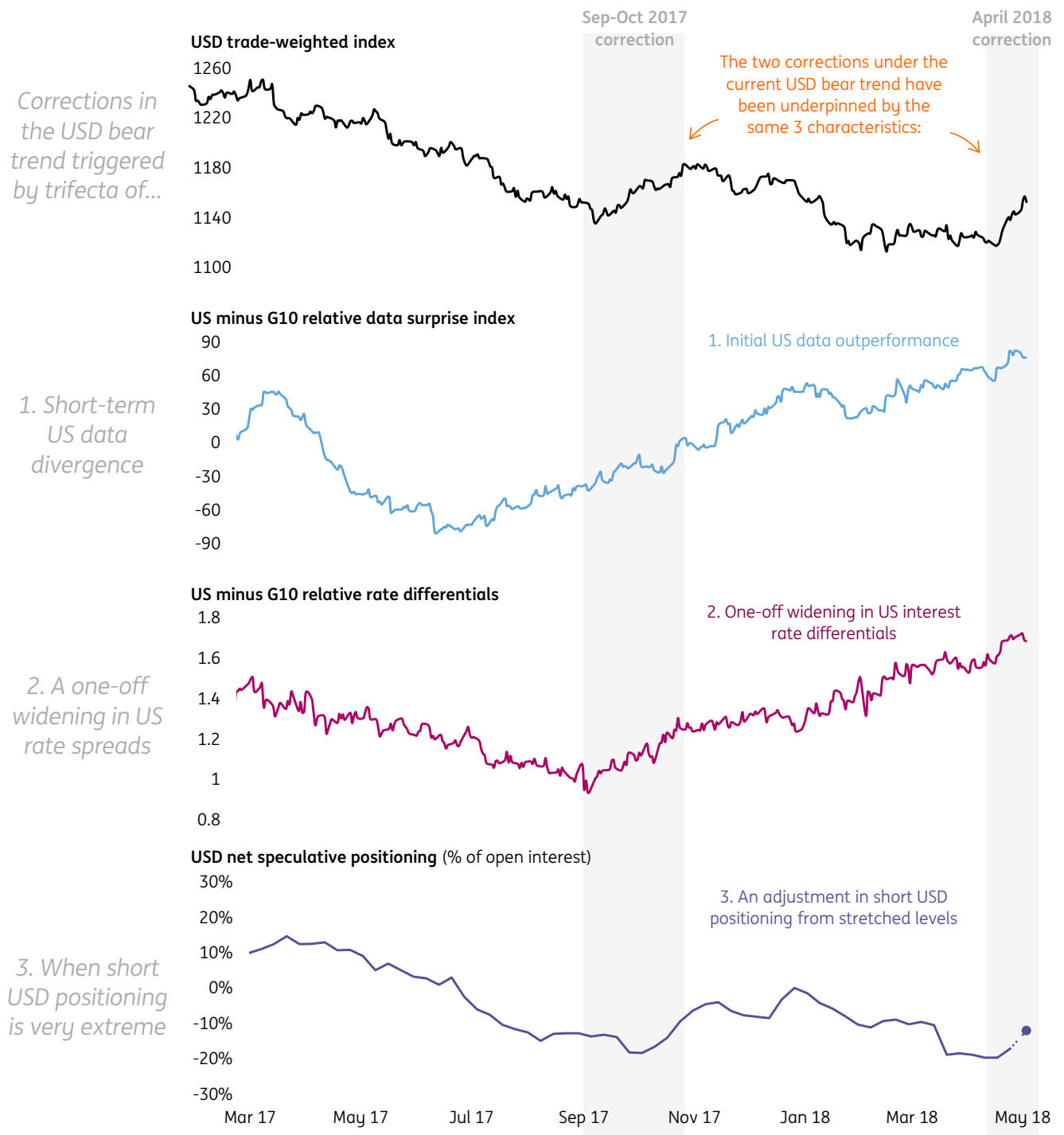
Source: ING. Notes: (1) Prior as of 06 April 2018; (2) *Our 2019 GBP forecasts remain under review

USD: Curb your enthusiasm

Larry David's "Curb Your Enthusiasm" may be more fitting than Larry Kudlow's "King Dollar" to describe the greenback's outlook

The US dollar has rallied 3% since mid-April – seemingly on the back of higher US rates and a growing sense that President Trump is a brilliant negotiator, rather than the architect of the next nuclear war. While we concede there is a case to be made for the dollar holding onto some counter-trend strength this summer, analysing the three key drivers of this USD move – and their temporary nature – means we do not see much further scope for dollar upside.

Anatomy of a USD correction: Counter-trend rally triggered by a trifecta of factors



Source: ING, Bloomberg

Peak optimism in the dollar

When dissecting the anatomy of this USD correction, we feel it exhibits all the hallmarks of a short squeeze. Positioning had clearly been stretched – and latest data show long EUR positions of leveraged investors being slashed to their lowest since Nov 2017, that to us is reminiscent of FX markets adopting a “let’s clear out and start again” mantra.

This sentiment hasn’t transpired without any catalyst. What we’ve seen prevail over April is the theme of US economic divergence (evident in the data), leading to policy divergence in market – effectively fuelling the adjustment in short USD positions.

Is the start of a genuine period of US economic divergence?

Now the key question for global FX markets is whether this is the start of a genuine period of US economic divergence – or whether the theme of Rest of the World economic convergence that underpinned market dynamics at the start of the year is still alive. We remain convinced over the latter and don’t think this USD correction lasts for two reasons: (1) we’re at peak short-term economic divergence and (2) policy divergence will have one-off and short-lived impact on FX markets.

FX markets have already been adjusting to the softer data outturns in the RoW

Peak economic divergence

Rather than outright US economic outperformance, the recent divergence has been more a function of data in the Rest of the World (RoW) underperforming over-exuberant expectations (Figure 1). While much of this underperformance may have been due to temporary factors (eg, weather, flu and strikes in Europe), we’ve also seen a phenomenon where Trump-led trade and geopolitical risks have deflated animal spirits in the RoW – more so than in the US. Perhaps this is due to the less open US economy.

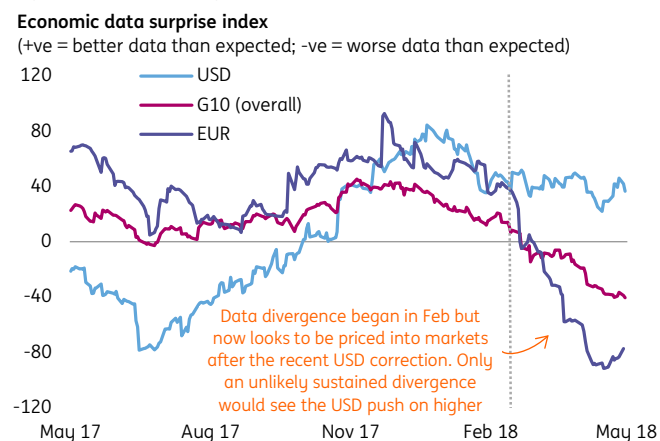
We suspect this divergence – especially in economic surprise indicators – is at its peak now

These do not strike us as enduring factors that lead to an ongoing cyclical divergence between the US and the RoW. Equally, FX markets have already been adjusting to the softer data outturns – with investors proportionally discounting those economies which have underperformed the most in recent months (Figure 2).

We suspect this divergence – especially in economic surprise indicators – is at its peak right now. Eurozone growth should still print above 2% this year – the European Commission has recently confirmed its forecast at 2.3% - and China should still be growing at 6.7/6.8%.

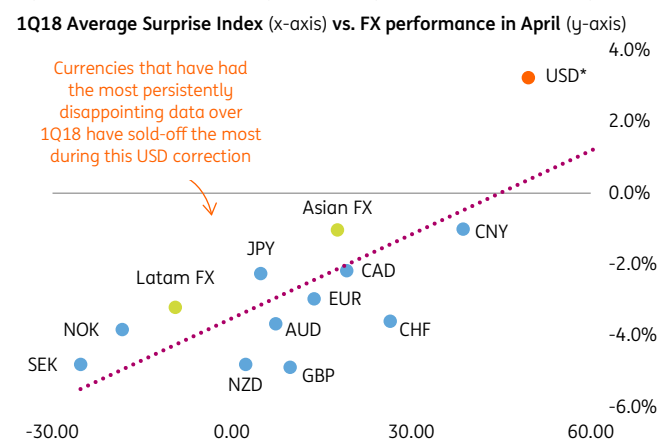
This should help to restore the US-RoW economic convergence story over coming months and deliver the kind of benign dollar decline seen between autumn last year and this January. In particular let’s see whether European Industrial Production (IP) bounces back from the effects of weather and strikes in February. The German March IP release, due 8 May, could be a useful barometer here.

Fig 1 Sharp divergence in US vs. G10 macro data outturns



Source: Bloomberg, Citigroup

Fig 2 Underperforming economy = Weaker currency



Source: Bloomberg, Citigroup, ING estimates

Only 30% of the move in EUR/USD lower over the past few weeks was caused by the relative rate spreads

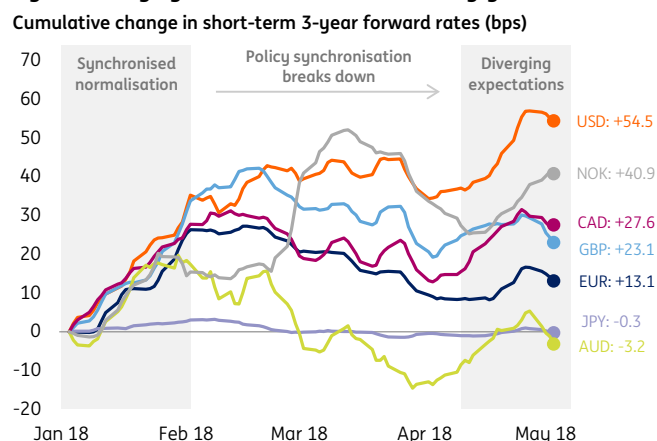
(Near) peak rate divergence – and a weak relationship with FX anyway

We see the recent EUR/USD decline as primarily positioning driven rather than caused by the material re-pricing of the relative Fed versus ECB outlook. This is corroborated by our short term financial fair model, which suggests that only 30% of the move in EUR/USD lower over the past weeks (from 1.23 to below 1.20) was caused by relative rate spreads. Indeed, the rise in UST yields has been rather limited over this period.

We cannot completely rule out a little further widening of US yields relative to the Eurozone (particularly if US inflation data picks up further). However, even if this occurred, it would not necessarily dictate large upside in the dollar.

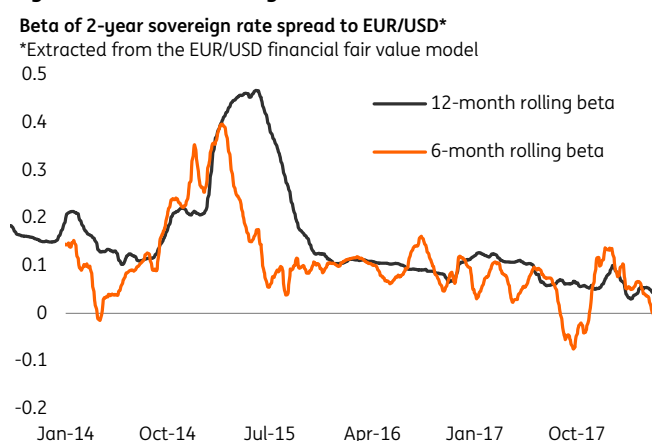
This is because of the dollar’s muted sensitivity to rising US yields. This is clearly depicted within our short-term EUR/USD financial fair value model which shows historically the low sensitivity of EUR/USD to short term rate spread (Figure 4). Moreover, the EUR/USD beta to rate spreads estimated over a 6-month time horizon (within our model) actually turned negative again, serving as a reminder of the dollar’s inability to benefit from higher rates over the past two quarters.

Fig 3 Policy synchronisation has seemingly broken down



Source: Bloomberg, ING

Fig 4 Muted sensitivity of EUR/USD to rate differentials



Source: Bloomberg, ING model estimates

A further 25bp rise of 2-y UST yields (other things being equal) would only lead to EUR/USD depreciation of 1%

More hawkish Fed may not lead to an overly strong USD

From this perspective, and assuming the current relationship/sensitivities hold, we see only a very limited upside to the dollar should the market price in an even more hawkish Fed tightening cycle.

As an example, we estimate that a further rise of 25bp in 2-y UST yields (other things being equal) would only lead to EUR/USD depreciation of 1% given the ultra-compressed sensitivity of the dollar to US rates (as per Figure 5, this is also evident in the wider USD trade weighted index, which has clearly lagged the move in relative rates).

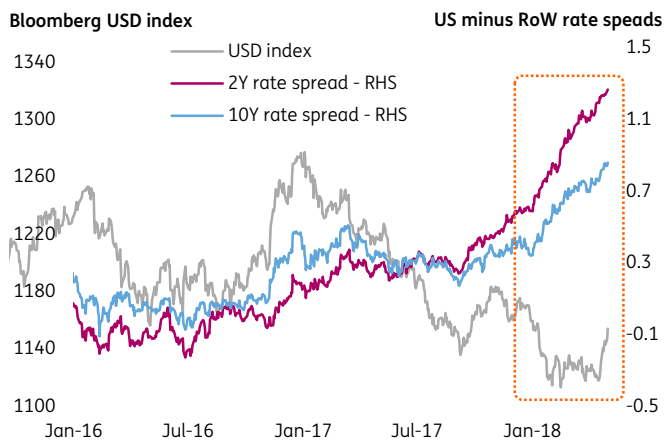
With plenty already priced in for the Fed (60bp worth of hikes for this year and additional 40bp for next year), the bar for a material hawkish re-pricing is set quite high.

1.1500 being a EUR/USD trough under more hawkish Fed re-pricing

Under an even more hawkish scenario for the Fed, whereby the market drives 2-y and 10-y UST yields higher to 3.00% and 3.50% respectively (or around 50bp higher from current levels) our model suggests a trough for EUR/USD at around 1.1500. **But this is if, and only if, EUR/USD is driven by rate differentials alone and assumes no risk premia.**

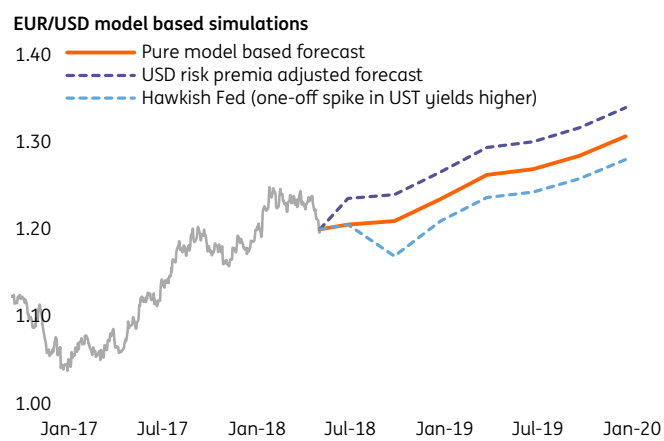
Such relatively limited downside in light of such a meaningful projected rise in UST yields underscores the very muted and compressed EUR/USD sensitivity to yields (as clearly witnessed over the past two quarters).

Fig 5 Broad USD index has been lagging moves in rates



Source: Bloomberg, ING estimates

Fig 6 Higher EUR/USD seen in 2019 under most scenarios



Source: ING model estimates

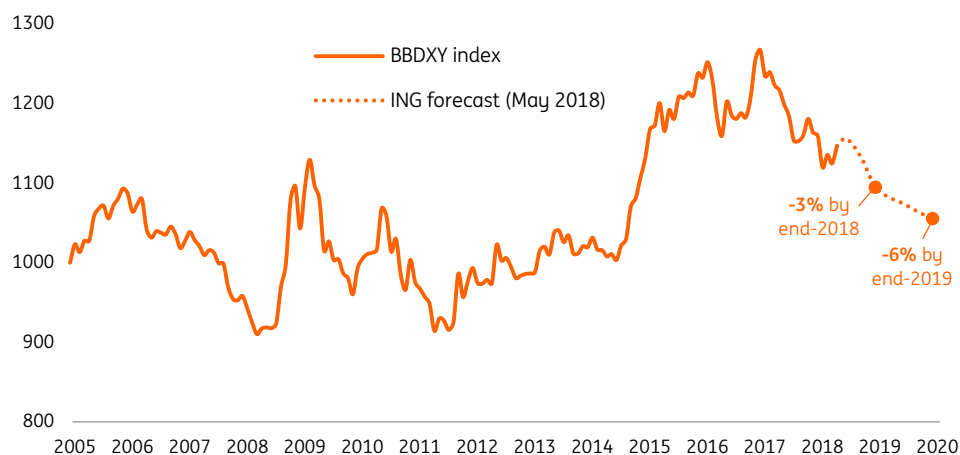
2019 EUR/USD outlook

While we recognize the limited EUR/USD upside potential in coming months, we retain a high conviction view for the pair to break above 1.30 during 2019 as: (a) the Fed’s tightening cycle will be at a more mature stage; and b) front-end EZ yields start rising meaningfully in response to the end of ECB QE and the eventual hike in deposit rates.

Our pure model-based estimate sees EUR/USD moving above 1.30 in 2019 in response to the expected cumulative decline of 60bp in the US-EZ 2-year sovereign yield spread. This is depicted in Figure 6, which shows the pure model-based path for EUR/USD stemming from our forecast for UST and Bund yields for this year and next (note that this does not include any USD political / fiscal / trade risk premia priced into the dollar profile).

We also provide a hawkish Fed scenario where UST yields rise more meaningfully than our team’s baseline scenario, by an extra 20bp across the curve. Even then, the EUR/USD downside is still limited to the 1.15 mark and the pair still appreciates over the forecast horizon.

Fig 7 ING’s forecast for trade-weighted USD out to end-2019



Source: ING estimates

Protectionism to return in June, risks to USD/JPY

In early February we cut our USD/JPY forecasts based on what we thought would be a protectionist risk premium being built into the dollar. At the time the Trump administration had just initiated anti-dumping duties in the solar panel and washing machine sectors – shortly to be followed by proposed tariffs in the steel sector and then on US\$100bn worth of Chinese imports in response to alleged IPR theft.

Some trading partners acquiesced to tough US trade policy in April...

April, however, saw a distinct calming in those tensions. Not only did Trump’s hawkish foreign policy stance on North Korea appear to be paying off – but trading partners appeared to acquiescing to some of the Commerce Department’s tough rhetoric.

For example, South Korea accepted quotas on its steel and aluminium exports to receive permanent exemptions for the tariffs. The likes of Canada, Mexico, Brazil and Australia may be considering something similar. More positive rhetoric on NAFTA emerged too.

...but China and the EU are another matter altogether

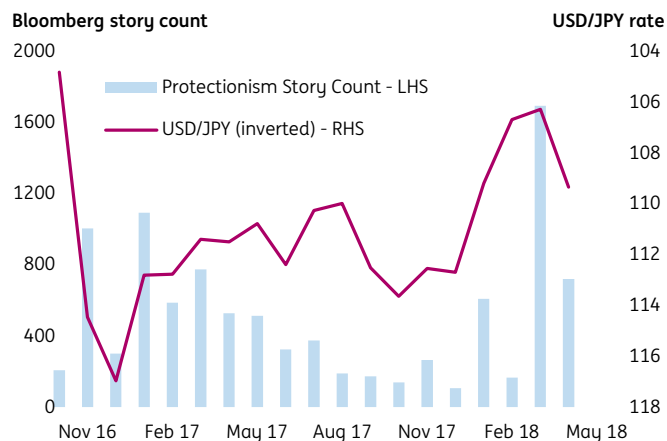
China and the EU are another matter completely. Both are preparing retaliatory tariffs should the US go through and implement their proposals. June looks the period when this could flare up again.

On the Chinese side, it will be late May/early June when President Trump decides which of the proposed tariffs on China will stick. US industry has an opportunity to protest against the proposed tariffs on a list of 1,300 Chinese goods at a hearing on 15 May.

Late May/early June will be when the US decides which of the proposed tariffs on China will be implemented

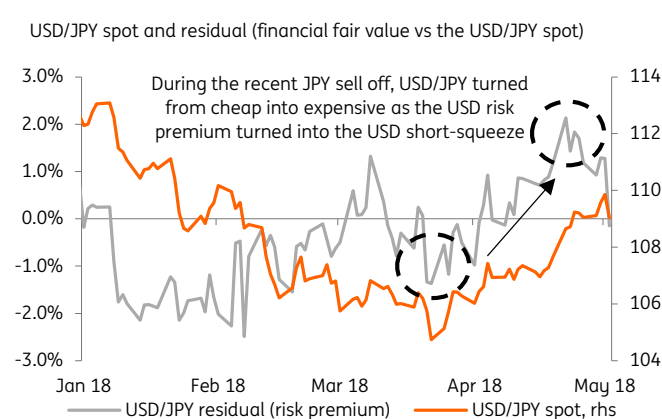
We doubt Beijing can offer enough in early May to significantly water down these tariffs – eg, a cut in auto import tariffs/opening up the Chinese financial sector to foreign investment. Instead we look for a residual of those US tariffs to be implemented in June and the Chinese to reciprocate.

Fig 8 Protectionism drifts out of the headlines in April



Source: Bloomberg

Fig 9 USD/JPY financial fair value: Risk premia removed



Source: ING

For the EU, exemptions to the steel tariffs have been extended until early June. If the US implements those tariffs, the EU Commission has indicated that it will retaliate with tariffs on 185 product groups. In addition to steel and aluminium they mostly include products that hurt the local economies of important American politicians

June could prove messy for EU-US trade relations

The key for the US-EU trade dispute is that Trump has mentioned a 25% tariff on auto if the EU indeed retaliates. That would be one with a significant impact on the European economy and a large step in terms of tit-for-tat. Given there is little indication that the matter will be resolved for now, June could prove messy for EU-US trade relations.

A protectionist stance has served Trump well in the opinion polls. The likely increase of protectionist rhetoric in June and the approach of US mid-term elections in November suggests it’s too early to call the ‘all-clear’ on protectionism. In short we think a risk premium can be built back into the dollar from late May/early June onwards.

Structural factors support a multi-year USD bear trend

The true 'divergence' that we're focusing on is the difference in the US and EZ external positions

Our medium-term bullish EUR outlook rests on the view that portfolio flows return to Europe

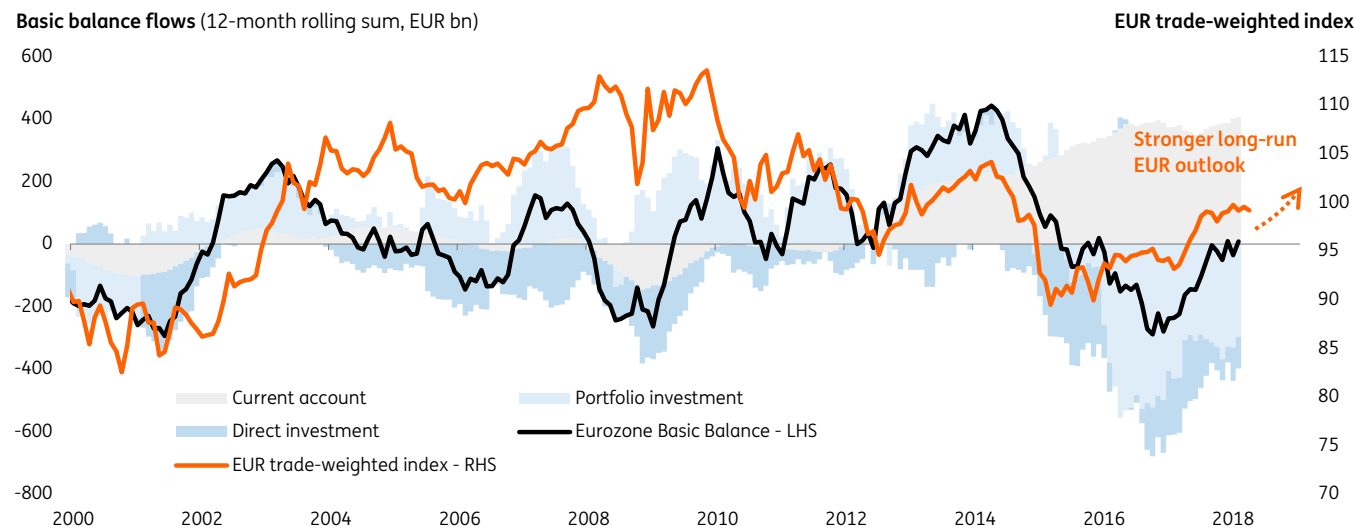
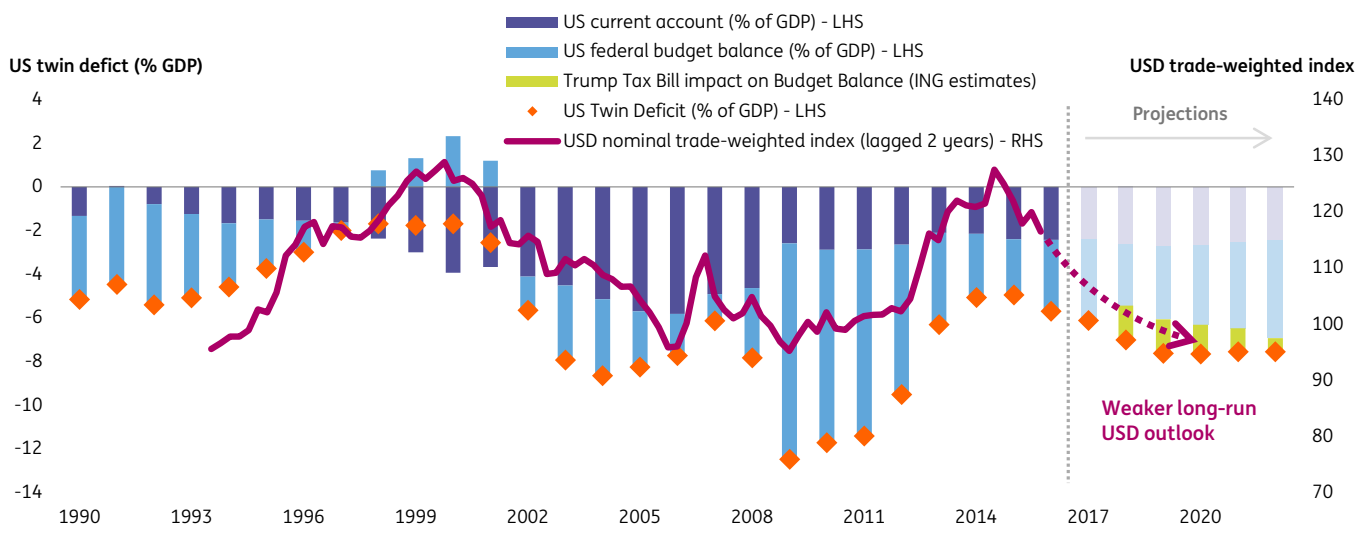
The outlook for the EZ basic balance creates a positive backdrop for the EUR over the next two to three years

The true 'divergence' that we are focusing on is in fact the difference in the long-run outlooks for the US and Eurozone external positions. Big US budget and current account deficits have historically weighed on the USD (Figure 10) – though we acknowledge that 'twin deficits' only become an active issue for currencies when there is a strong enough catalyst. The RoW growth convergence story is one such catalyst; for a US economy in the latter stages of its economic cycle, relative US asset valuations and better goldilocks growth opportunities elsewhere should exert a downward force on the USD.

Beyond the ECB normalisation story, we believe the Eurozone's strong external position also makes for a constructive medium-term story for the EUR. We've been making the point that the ECB's QE programme has driven investors out of European markets since 2015 (particularly debt assets). Our medium-term bullish EUR outlook rests on the view that portfolio flows return to the Eurozone quicker than the current account narrows.

The ECB's Benoit Coeure threw light on these issues in a [speech last year](#) – especially addressing how 'international portfolio balancing considerations can drive a wedge between expected future short term rates and the exchange rate'. We're convinced that this international portfolio rebalancing story has helped the EUR since President Draghi's speech in Sintra last June – and convinced that the normalisation of ECB policy (and subsequent portfolio adjustment) will drive EUR/USD towards 1.40 over coming years.

Fig 10 Diverging external balance of payments dynamics in US and Europe lend support to structural USD weakness



Source: Bloomberg, ECB, ING

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