PICTET 1805

Flash Note

Currencies: US dollar

Is there an end to the US dollar's weakness?

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Following disappointing US economic data and another failure to form a Republican majority on key legislation, the US dollar has slipped to a 10-month low, at 94.68 on 18 July.

This extreme USD weakness has led to strong negative market sentiment, as highlighted by speculative positions on the futures market.

Although we acknowledge that the foundations (rising inflation and fiscal stimulus) of our strong US dollar view have weakened, we think that the combination of high USD pessimism and improving US data should pave the way for a significant USD rebound.

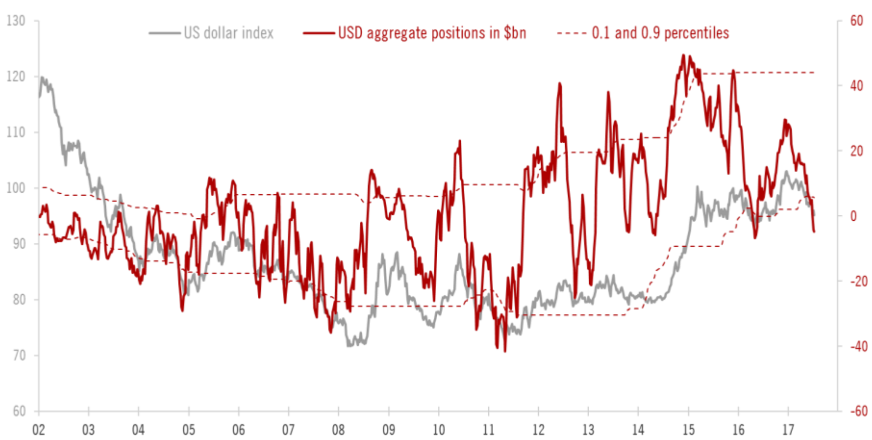
Consequently, we do not think the time is right to be overly negative on the US dollar, especially as the EUR/USD rate is close to major resistance levels and optimism in other non-USD currencies is very elevated.

The US dollar, as measured by the US dollar index, moved to a 10-month low on 18 July following disappointing US data, notably consumer price inflation (CPI), and the failure of the Trump administration to pass a vote on healthcare reform. The persistent weakness of inflation could lead to downwards revisions to the Fed's estimates for the Fed funds rates, while the ongoing failure to reach consensus among Republicans on key legislation does not bode well for the ratification of a non-negligible fiscal stimulus in the coming months.

Is the pessimism on the USD warranted?

The market's concerns about the Fed's ability to raise rates in a low inflationary environment and the diminishing prospect of a fiscal stimulus have led to elevated levels of pessimism around the US dollar. The aggregate of CFTC non-commercial (i.e. speculative) USD futures positions is now net short, and close to its lowest levels in four years (*see chart 1*).

Chart 1: US dollar index vs. CFTC aggregate long USD positions (in USD bn)



Source: Pictet WM – AA&MR, Thomson Reuters

Although we acknowledge that our positive outlook for the US dollar may prove too optimistic in the light of the potential deterioration in the growth and inflation outlook, we remain confident that the US dollar will rebound in the second half of the year. The bar remains high for the Fed not to raise rates in December, while the start of the reduction of the Fed's balance sheet in October seems set in stone. Furthermore, US activity should prove robust in

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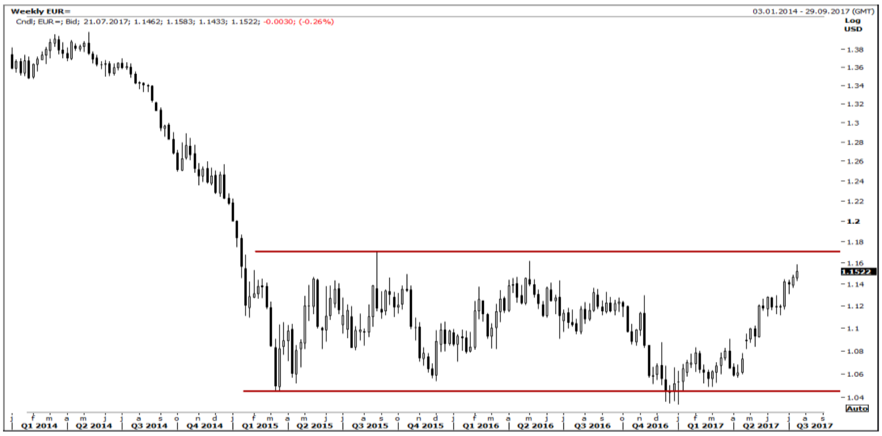
the second half of the year, supporting the greenback. Given the high pessimism surrounding the currency, this should pave the way for a significant rebound of the US dollar.

Is there too much optimism in other currencies?

Part of the reason for the weakness in the US dollar also comes from the strength of the euro. Looking at CFTC speculative net euro positioning, market sentiment is close to the highest levels in eight years, reflecting elevated optimism. Given muted inflationary pressure in the euro area, moderating economic growth and the ECB's persistent stance of accommodative monetary policy, the risk is high that market will be disappointed by a prudent ECB in the next few months. Furthermore, the strength of the euro is weighing on the inflation outlook, favouring a very gradual pace of tightening.

Meanwhile, the EUR/USD rate is fast approaching the top of its multi-month consolidation (1.1711, August 2015 peak, *see chart 2*). Based on the assumptions above, a sustained break above this peak is unlikely in the coming months.

Chart 2: 1 EUR in USD terms (weekly data)



Source: Pictet WM – AA&MR, Thomson Reuters

The US dollar has also suffered against commodity currencies. Once again, in the case of the Australian and New Zealand dollars, the combination of muted inflationary pressure, the significant impact of foreign exchange in the economic outlook and extreme long speculative positions (*see chart 3*) do not support a positive view on these currencies. In addition, both countries' central banks remain concerned about the strengthening of their currencies. Consequently, despite their recent appreciation, we expect Antipodean currencies to weaken against the US dollar in the coming months.

A rebound of the USD remains the most likely scenario

Our strong USD scenario in 2017 was mostly based on an active Fed, a robust growth outlook boosted by fiscal stimulus, and rising inflation caused by reduced slack in the labour market. We acknowledge that these foundations are less strong than expected, pointing to lower USD upside potential.

That said, we remain very sceptical that the US dollar could weaken significantly further from current low levels. True, a fiscal stimulus is less likely and inflation has disappointed. However, market expectations for a fiscal stimulus are pretty low, and inflation is likely to pick up in the next few months given still-loose US financial conditions and the strong labour market. In a nutshell, extreme negative sentiment on the greenback and improving US data should pave the way for a significant US dollar rebound. Consequently, we do not think the time is right to be overly negative on the US dollar.

Chart 3: CFTC net AUD non-commercial FX positions (based on futures only)

Source: Pictet WM – AA&MR, Thomson Reuters