PICTET 1805

Flash Note

Currencies: US dollar

Long-term US dollar cycle has probably passed its peak

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The US dollar index has declined significantly this year, challenging our constructive view on the US dollar.

Disappointment regarding potential US tax reform, the decline in US inflation, the significant overvaluation of the greenback and strong economic recovery in the rest of the world explain a large part of the US dollar's decline.

In 2018, the slowdown in US activity and the probable end of the Fed tightening cycle in March are likely to weigh on the USD. However, the magnitude of the decline should be lower than this year given mitigating risk factors such as interest rate differentials and relative valuation.

Taking into account these new developments, our new estimate for the EUR/USD rate for end-2018 is 1.24 vs. 1.19 at end-August. We expect a rebound in the US dollar during the remainder of 2017, pushing the EUR/USD rate down to around USD1.15.

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A number of developments have contributed to a broad-based weakening of the US dollar since the start of the year (the US dollar index has fallen around 10%), with an inevitable impact on the currency scenario we set out at the beginning of this year. To understand why the US dollar has depreciated and form a better idea of what is in store for it in the future, we need to look at a number of the key drivers of currency trends. We have identified seven: fiscal policy, economic growth (or business cycle), inflation, monetary policy, interest rates, valuation and market momentum. Surprisingly, although most of them apply to other asset classes as well, the US dollar has borne the brunt of recent shifts in these drivers, while other assets, such as equities, have been largely preserved. Below, we discuss the possible impact of each of these factors on the US dollar's recent weakness and their possible impact through to the end of 2018, as well as to the end of this year.

Fiscal policy

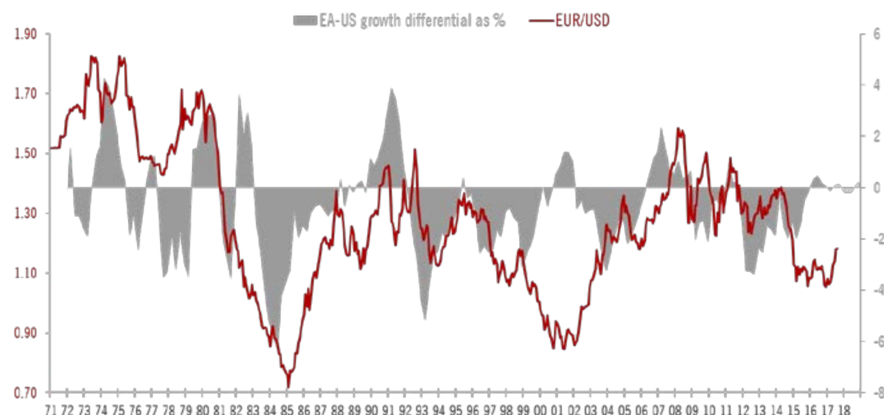
The rally in the greenback in the weeks following the election of Donald Trump in November 2016 was largely due to expectations of pro-growth measures, especially tax reform, which were seen as having the potential to lift the US growth outlook. This was our own scenario at the start of the year. In the event, the Trump administration has thus far been unable to craft a majority in Congress for many of its proposals (even though the Republicans control both houses). Expectations for the US dollar have been hit by this lack of progress. Looking forward, the immediate concern for Congress is the debt ceiling which needs to be lifted in the coming weeks, while the approach of mid-term elections (to be held in November 2018) suggests that any fiscal easing needs to be ratified before January. Given the short time available, it will be very difficult for the Trump administration to have a comprehensive tax reform package ratified by Congress. Consequently, we no longer expect any meaningful fiscal boost from Washington DC.

Growth

Having troughed in 2009, the US business cycle is already mature so that without a fiscal boost, a slowdown in US activity in 2018 seems likely. Indeed, our in-house scenario now expects a slowdown in US GDP growth from 2.2% in 2017 to 1.7% in 2018. This slowdown is likely to weigh on the US dollar next year. But one needs to understand how other economies are likely to behave relative to the US. For example, the growth differential

between the US and the euro area is unlikely to be significantly negative for the greenback relative to the euro (*see chart 1*).

Chart 1: EUR/USD and EA-US growth differential (with PWM-AA&MR estimates)



Source: Pictet WM – AA&MR, Thomson Reuters

Inflation

At the beginning of 2017, reduced slack in the US labour market, loose financial conditions and the prospects of a fiscal boost all pointed towards core PCE inflation rising to slightly above the Fed's 2% target. But since then, instead of rising, core inflation has actually declined in the US. This has weighed heavily on the US dollar through lower long-term nominal rates and expectations that the Fed will move cautiously to normalise monetary policy. Looking forward, core PCE inflation is expected to remain broadly stable below the Fed's 2% target through the rest of 2018 suggesting reduced prospects for further rate hikes.

Monetary policy

Based on our scenario for a slowdown in activity and for inflation to remain below target, our in-house scenario now only expects one US rate hike in 2018 (in March). True, the reduction in the Fed's balance sheet, likely to start in October this year, should offer some support for the US dollar. However, the possibility that the Fed is near the end of its tightening cycle while other central banks, especially the ECB, are in the early stages of theirs does not bode well for the greenback. In short, monetary policy divergence, which has been a strong tailwind for the US dollar in recent years, is turning into a headwind. However, although monetary policy divergence will likely be a driver playing against the greenback, its impact over the next 12 to 18 months could be relatively subdued. Indeed, because markets have already heavily trimmed their expectations for Fed funds rates (at end-August, futures markets were forecasting little more than one rate hike up to the end of 2018), our in-house scenario of a quarter-point rate hike in December 2017 followed by a further rise in March entails a positive impact for the US dollar over the next six months (see *chart 2*).

Interest rates

Rate differentials are a critical driver for FX markets. So the decline in US long-term rates since December has weighed on the US dollar. In the meantime, European rates have trended somewhat higher on the back of improving macro data. Consequently, measures like the 10-year real rate differential have turned broadly in favour of the euro against the greenback. However, although the EUR/USD rate has tended to move in close tandem with this indicator since 2015, a wide gap has appeared since mid-May (see *chart 3*). Although we acknowledge that similar discrepancies have occurred before, the trends in both series tend to be well synchronised. So it is rather puzzling to see the euro trending significantly higher against the US dollar while interest rate differentials show no particular trend. Based on interest rates differentials, our view is that further upside potential for the EUR/USD rate is constrained, especially as this indicator is unlikely to improve in the coming months. Furthermore, the fact that US short-term rates are currently among the highest of any G10 country is supportive of the US dollar.

Chart 2: Expected Fed funds rate for end-2018

Source: Pictet WM – AA&MR, Fed, Thomson Reuters

Chart 3: Euro area – US 10-year real rates differential as %

Source: Pictet WM – AA&MR, Bloomberg

Valuation

One consequence of the long-term upcycle in the US dollar since July 2011 is that the currency is fundamentally overvalued. The equilibrium value of the euro versus the US dollar based on CPI-based purchasing power parity is around 1.22 (*see chart 4*). When the euro was trading at around USD1.04 at the beginning of 2017, market valuation was an active driver favouring the euro. However, with the EUR/USD rate close to 1.20, this may no longer be the case.

Market momentum

It is relatively difficult to estimate, let alone define, momentum as a driver of currency rates. That being said, it is interesting to note that with important elections in a number of euro area countries, including France and the Netherlands, significant political uncertainty hung over the euro in the early months of the year. In the event, with the election of Emmanuel Macron, a stronger relationship is in the course of being formed among the euro area's two main economies, Germany and France. By contrast, hopes of pro-growth policies in the US have been dashed by the chaotic developments surrounding the Trump administration. The expected slowdown in US growth next year and the possible end of the Fed's tightening cycle suggest some sort of shift in momentum, with the US dollar less 'in fashion' than it was. The recent breakout from the broad EUR/USD range of 1.04-1.17 that had prevailed since March 2015 may be evidence of this shift in momentum away from the USD.

Chart 4: Fair value of the EUR/USD rate based on purchasing power parity

Source: Pictet WM – AA&MR, Thomson Reuters

Strategic outlook for the USD

Our new scenario for US growth and the path of Fed tightening suggests that the two main drivers behind the USD upcycle that started in 2011 (economic growth and monetary policy divergence) have disappeared and that the peak in the long-term US dollar cycle is now behind us. The fact that it has lasted only five and half years (compared to six and half years for the past two upcycles) and without any extremes in USD overvaluation for any length of time makes this upcycle quite different from the others. Consequently, it is likely that the current USD down cycle will also be different from past

history, and that a sharp, multi-year USD decline like in 1985 or 2002 may not be in store for the greenback in the coming years.

In the event, our central scenario is that the euro is likely to rise further against the US dollar and should reach USD1.24 per EUR by end-2018 (compared with USD1.19 at end-August 2017).

Tactical outlook for the USD

But while key drivers suggest the US dollar could continue to weaken next year, the near term outlook for the US dollar could be different. Indeed, US activity is expected to remain firm in the remainder of 2017, whereas a modest slowdown is likely in the euro area. The Fed will remain active (balance sheet reduction in October and a quarter-point rate hike in December), while the ECB may be somewhat constrained in its plans for policy normalisation by euro strength. Finally, market sentiment is significantly negative towards the USD, as derived from speculators' positioning in the future market, while the greenback is severely undervalued based on short-term technical indicators. Such a backdrop favours a short-term rebound in the USD.

Although we acknowledge that the timing of any rebound is difficult to forecast, it is worth noting that the surge in the euro immediately after the peak of the previous USD upcycle in 2002 led to a roughly 19% appreciation of the euro over five months before it corrected by 6%. At that time, many risk factors such as valuation and interest rate differentials were significantly more negative for the US dollar than today. Given the 16% rise in the euro against the greenback in the last seven months, the risk of a correction therefore seems pretty high.

On the EUR/USD rate, a correction would likely push the euro back down to around USD1.15 by the end of the year.

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