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CURRENCIES: US DOLLAR

PATH OF LEAST RESISTANCE REMAINS TO THE DOWNSIDE

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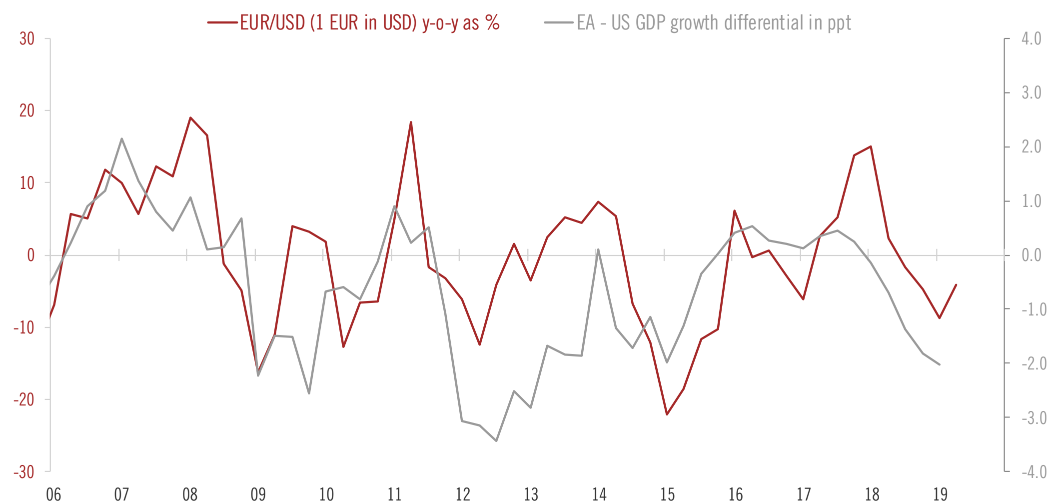
SUMMARY

- Despite a more dovish Fed, the US dollar has remained strong since the start of the year (as of 28 May, only the Canadian dollar and the Japanese yen had fared better).
- Weak global economic growth, notably as a result of trade tensions, has favoured the US dollar given its safe-haven status and high carry.
- Taking stock of the deterioration in the global growth outlook and higher trade tensions, we are reducing our bearish stance on the US dollar.
- However, we are of the view that most factors (e.g. growth and interest rate differentials, capital flows, fiscal health and valuations) still suggest the path of least resistance for the US dollar is to the downside.
- In particular, our projections for the EUR/USD rate is now USD1.11 in three months, USD1.13 in six months and USD1.15 in 12 months.

CHART 1: EUR/USD VS. GDP GROWTH DIFFERENTIAL



Source: PWM - AA&MR, Thomson Reuters, 29 May 2019

US dollar has remained strong

It is our belief that the US dollar is mainly driven by growth and interest-rate differentials.

In 2018, the dollar was particularly strong thanks to a tax-cut boost to the US economy (at a time when growth in the rest of the world was losing momentum) and a hawkish US Federal Reserve (Fed). The US dollar has remained strong in recent months despite the Fed's dovish shift at the turn of the year and a likely moderation in economic activity as the impact of tax cuts starts to fade.

Part of the explanation is to be found in the further moderation in global economic growth as trade tensions have continued to weigh on trade. Lacklustre growth outside

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the US means the attractiveness of the safe-haven and high-yielding US dollar has been difficult to match, especially as volatility in the FX market is at historically low levels.

Global political uncertainties on the rise

Unfortunately, and contrary to our expectations, global political uncertainties may stay elevated for some time. Trade tensions between the US and China have increased since the US administration raised tariffs on Chinese exports again in early May and China retaliated. In addition, the prospect of a no-deal Brexit has increased since the resignation of Theresa May.

Coupled with the Italian government's lack of fiscal discipline, trade and political uncertainties could weigh on business sentiment in the euro area and make any significant pickup in economic activity in the second half of the year quite challenging. In such an environment, any rate hike by the European Central Bank (ECB) is quite unlikely in 2020. As such, the euro, which has a heavy weighting in the US dollar index, is often considered the 'anti US dollar', and may have a tough time appreciating relative to the greenback in the coming months, meaning our relatively constructive stance on the euro relative to the US dollar needs to be scaled down.

Greenback's upside potential seems limited

At the same time, we remain somewhat sceptical about any significant upside potential for the US dollar.

First, higher trade tensions are increasing the pressure on the Fed to cut rates. Furthermore, the end of 2018 showed the Fed is sensitive to a tightening of monetary conditions and is concerned about an inversion of the yield curve. Rate cuts would likely dent the relative carry attractiveness of the US dollar, while it might also help global growth (notably through a lower cost of funding).

Second, US stocks' outperformance (notably thanks to the end-2017 tax cuts) as well tax-break induced repatriation flows boosted financial flows into US assets. It will be particularly hard for capital flows to match 2018. Furthermore, the euro area's balance of payments flows definitely support the euro over the dollar. In short, there is not a strong case for capital flows to significantly lift the greenback in the coming quarters.

Finally, long-term indicators such as valuations and budget deficits point to a weaker US dollar. Indeed, should trade tensions increase further, the US administration's discomfort with countries that have high goods surpluses with the US and an undervalued currency could continue to grow. In addition, moderation in US growth after a significant deterioration in the budget deficit usually does not point to US dollar outperformance.

Guidance maintained but magnitude lowered

Consequently, we are sticking to our view that the path of least resistance for the US dollar is to the downside in the next 12 months. However, the weakening global growth outlook and the recent increase in political uncertainties are forcing us to tone down our bearish stance.

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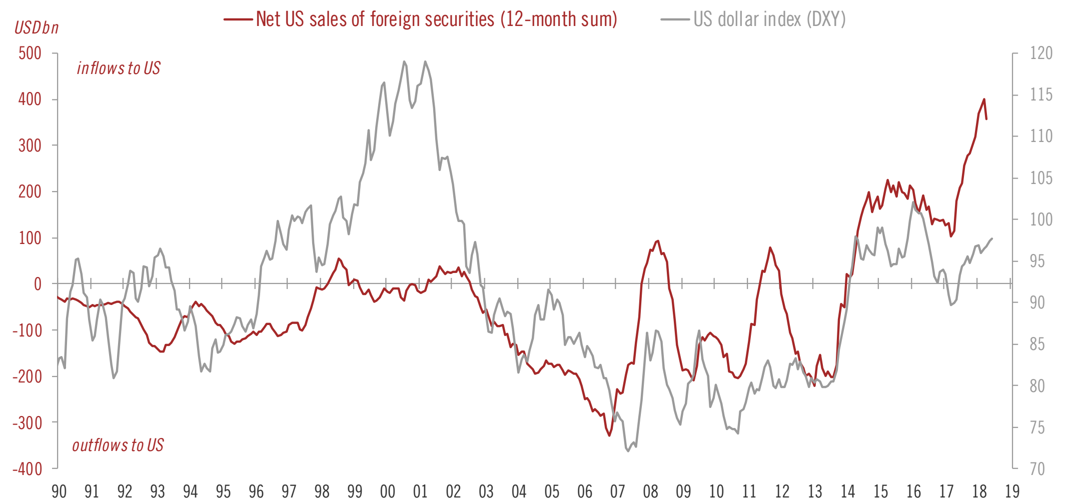
CHART 2: US DOLLAR AND NET US SALES OF FOREIGN SECURITIES (BONDS & EQUITIES)



Source: PWM - AA&MR, Thomson Reuters, 29 May 2019

We now see the euro remaining close to its current rate of USD1.11 over the next three months (compared to a previous forecast of USD1.14), followed by a moderate appreciation toward USD1.15 over 12 months (previously USD1.20). The Chinese renminbi could remain relatively weak as long as a trade tensions are not resolved, but we do not expect significant depreciation (see here). Our view that downside and upside potential alike remains limited for the euro and that the Chinese renminbi will stabilise relative to the US dollar (we expect the USD/CNY rate to remain slightly below the CNY7.00 threshold in the next 12 months) should continue to restrict FX market volatility.

The prospects of longer drawn-out trade tensions between the US and China (and its potential economic impact on the Chinese economy and global trade) make us more cautious on Antipodean currencies, especially as their central banks seem to be leading the charge on monetary policy easing. Because futures and option markets have not been showing extreme levels of stress, sterling is also likely to trade on the weak side in the next few months as markets try to adjust to the rising possibility of a hard Brexit (see here). We favour a sterling exchange rate of around USD1.24-1.25 over the next six months before a rebound to USD1.30 as British lawmakers finally turn back to public opinion to resolve the Brexit impasse (either through an election or a referendum).

Overall, recent global developments underpin our positive stance on defensive currencies such as the Japanese yen and, to some extent, the Swiss franc. We would add gold to this list, especially as the second half of the year tends to be seasonally strong for it.

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