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Investment Strategy Bulletin

Fed over-delivers...and the dollar bows

Investment Solutions 31 January 2019

- The removal of the hiking-bias by the Fed in its January statement was a crucial development in the dollar-story for 2019
- We have been advocating USD downside since Q4 18 but now think the risks are skewed towards a more rapid and steeper depreciation
- Within G3 FX, we remain overweight (mainly) JPY and (less so) EUR in our portfolios
- Elsewhere in G10, we expect meaningful appreciation in NOK, CAD and AUD on account of oil prices and improved risk appetite
- In emerging market currencies, the scope for the rally extending is stronger now. We anticipate gains in RUB and BRL and suspect that – despite political hurdles – TRY and ZAR will rally as carry trades come back in vogue

Since Q4 18, we have been proponents of a bearish dollar view. Around the turn of the year, we forecasted a trade-weighted (TW) dollar depreciation of about 8-10% for 2019. We have thus gone underweight the USD in our portfolios accordingly vs (mainly) the JPY and (less so) the EUR.

There were two core arguments to our negative USD view. First, we believed that there was too much hype and excitement priced into the dollar due to the US fiscal stimulus. The economy was running on a “sugar-high” from an ill-timed stimulus that lacked the ingredients to drive growth structurally higher. Consequently, we concluded that the fading beneficial effects (later in 2019) would soon expose the US economy to its twin deficit problem, and lead to a weakening of the USD. Second, interest rate differentials between the US and the rest of the world (RoW) were running sky-high and were out of line with relative economic developments. We believed that this was unsustainable and the narrowing of the US-RoW rate differential would weigh on the USD.

Things have played out largely in line with this view since then, with the TW USD depreciating nearly 3% from the mid-November high, and JPY rising by more than 4.5% (EURUSD up by 2.5%). **Now yesterday’s pivot by the Federal Reserve Bank (Fed) is adding more fuel to the “dollar-downside fire”.**

For sure, Fed-speak has erred towards the dovish side since late December, but we feel that yesterday Fed Chair Jerome Powell over-delivered. Apparently, the market had gradually positioned for a reiteration of the “patience” language, and **we think it was caught by surprise by the hiking-bias being removed from the Fed statement**. Until December of last year, the Fed had communicated that “... some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity...”. In its January statement, the central bank dropped this reference, saying instead: “... the Committee will be patient as it determines what future adjustments to the target range for the federal funds range may be appropriate to support these outcomes.” This marked a clear shift towards a neutral stance, corroborated by a more dovish characterisation of inflation expectations and a softer language on balance sheet policy.

The dollar has reacted negatively to the news, dropping short of 1% as US bond yields fell, most notably at the short end of the curve (implying that the yield curve has steepened somewhat).

We maintain our bearish dollar view, **but now think that the risk is skewed towards a more rapid and steeper depreciation**. So how should investors pick their USD shorts?

In the G3 (US, Japan, EU) forex space, we maintain our **overweight in JPY and EUR.** In early January, we suggested that the steep drop in USDJPY from 114 to 108 (between November and early January) hinted at a short period of consolidation and that the market was likely to take a breather. We now think that this period has ended and expect renewed downside pressure. The rally in risk assets may represent an offsetting force for yen appreciation, but we believe that the downside pressure on US yields will more than counterbalance this: correlations between USDJPY and risk assets (MSCI World Equity Index) have been falling recently, while those between the currency pair and US yields have remained exceptionally high. Above all, fundamentally the JPY remains undervalued. Turning to the euro, we see upside pressures emerging, but would highlight that the common currency is currently more of a “dollar play” as it is lacking positive idiosyncratic factors given the deterioration in regional economic activity. Our expectation is that the euro area slowdown will stabilise since domestic demand remains strong and external headwinds are likely to abate. If so, this should afford the euro more upside momentum. As an additional argument, we would point out that given where interest rates are currently, the bar for the European Central Bank to hike this year is lower than that for the Fed.

On **sterling**, we would refrain from riding any rallies for the moment as we discussed in our recent Investment Strategy Bulletin ("Brexit update: UK MPs barking up the wrong tree"). The Brexit situation has become even more perplexing following the developments in the UK House of Commons, subjecting GBP to even more uncertainty and headline risk. Our view is that eventually there will be an extension of the Article 50 deadline, but we would prefer to wait until this is confirmed (potentially in late February) before turning outright bullish.

In other currency pairs, we summarise our preferences as follows:

Bullish NOK and CAD: In both cases, monetary policy expectations are somewhat under-priced (especially in Canada) relative to activity and inflation dynamics, and oil prices are rebounding convincingly. Oil supply cuts (OPEC+ producers have agreed to reduce output by a combined 1.2 million barrels a day) are likely to continue lending support to prices for the near future.

Bullish on AUD: Data in Australia has moderated recently, but we think that the market is too bearish to have priced in a more than 50% probability of a rate cut this year. Additionally, AUD is a pro-risk currency, which suggests the odds are more than even that the rally in equities will push it higher.

In **emerging market currencies, we think the scope for upside is now stronger than it was at the beginning of the year.** The Fed shift suggests that – at least for the time being – the risk of higher rates has been taken off the table, something which should open the taps of portfolio flows to EM economies.

Furthermore, marginal improvements in the US-China trade negotiations (although risks remain) and (tentative) green shoots in Chinese economic numbers (retail sales and industrial production beat expectations in December, while the January PMIs came in a tad better than consensus forecasts) should add to the tailwinds.

We expect outperformance in **RUB** (due to oil prices and strong domestic fundamentals) and **BRL** (as the recovery in Brazil is still young and chances are rising that the Bolsonaro administration will proceed with structural reforms). Despite political uncertainties in South Africa and Turkey, ZAR and TRY are likely to perform strongly in this environment, as improved risk appetite combined with a dovish Fed is likely to fuel carry trades.

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