Economist's Weekly Market View

Tuesday, 12th June 2018

Downside risks remain for the dollar

At the start of the year, we took the view that while the US dollar was in long term decline, it would likely enjoy periods of strength during 2018. The basis of this view was that the extreme short positions built up against the US currency in forex markets could well unwind, while President Trump's cuts in US corporate taxes were likely to trigger dollar inflows as funds were repatriated by large corporates to the US.

The euro rose to a high of $1.25 early in the year, before the dollar started to rally, making significant gains in the past two months. As well as the above factors, the dollar was aided by strong US data. Widening interest differentials also helped the currency.

The euro has found support at around the $1.16 level in the past week. The EUR/USD rate traded in a $1.05 to $1.16 range for most of 2015-16, so the $1.16 level was always going to provide strong technical support for the single currency.

We are still of the view that the US dollar will weaken over the longer term. A number of factors drive this assessment. We are concerned about the policy mix in the US. The expansionary fiscal policy will lead to a sharp jump in the US budget deficit and thus a big rise in the supply of Treasury bonds. It will also put upward pressure on the US balance of payments deficit. These factors point to a lower dollar.

We are also concerned that the US economy could slow sharply once the fiscal stimulus fades, and as higher US rates start to impact on activity, again undermining the currency.

Finally, the dollar is now at quite elevated levels against a range of currencies, pointing to downside potential. The dollar is close to 20% higher on a trade-weighted basis than for most of the period 2005-2015.

Notably, EUR/USD traded in a $1.20-1.50 range for virtually all of the period from 2003 to 2015. We expect that the euro will eventually return to this range given the on-going improvement in the Eurozone economy.

Traders and investors, though, are more interested in the near terms prospects for the dollar. The relative strength of the US economy, widening interest rate differentials, stresses in some emerging markets and, indeed, in some peripheral Eurozone markets too, are all supportive of the US currency.

However, further gains may be prove difficult now that FX positioning has turned more neutral for all the major currencies, with dollar short positions having being largely unwound. Even if the dollar continues to rise against emerging markets currencies, further gains against the euro may prove difficult.

Indeed, the euro is already showing signs of stabilising on expectations that the ECB will soon signal that it will end net asset purchases under its QE programme by the end of the year. In any event, if support for the euro at $1.15-1.16 did give way, there is further strong technical support for the single currency at the $1.12-1.13 level.

Overall, we think that the major move upwards by the dollar against the euro during the last couple of months is largely over. We would expect the EUR/USD rate to now stabilise and trade in a $1.16-1.20 range over the summer. It should rise above the $1.20 level later in the year as the ECB brings net asset purchases to an end and concerns re-emerge about the twin deficits in the US and that economy's growth prospects over the medium term.

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