Economist's Weekly Market View

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Dollar looking for direction

The euro was on a steady upward path against the dollar for much of this year as it climbed from $1.04 in early January to around the $1.20 level by August. However, the euro-dollar rate has been range bound since then, with trading confined to a narrow $1.16-1.20 corridor, as some of the shine came off the single currency while the dollar turned more stable.

Part of the reason for this was the ECB announced in the autumn that it was extending quantitative easing, or its asset purchase programme, until at least September 2018, albeit at a reduced rate from the start of next year. It also continues to indicate that interest rates will remain at their current, very low levels well past the end of net asset purchases under its QE programme. Thus, markets do not see a hike in ECB rates occurring until 2019, with short-term interest rates not expected to turn positive until 2020.

The dollar has been more stable in recent months too. Indeed, it has recovered some of the ground lost to currencies earlier in the year, such as the Aussie, NZ and Canadian dollars, Chinese yuan and sterling. It has been helped by the fact that the Fed reaffirmed that it would continue to raise rates at a steady pace and indicated that the next rate hike was likely to occur before year end.

The Trump Administration has also been making some progress with Congress on its tax cut plans, which it wants to see implemented next year. US data have been solid too recently, with the economy growing at a 3% annualised rate in the last two quarters.

As a result, there has been a firming of market expectations in regard to US rates since the summer. Markets now see the next US rate hike occurring at end 2017, compared to end 2018 previously, while they also expect US rates to rise to 2% by end 2019 compared to 1.5% a couple of months back.

We see the upside potential for the dollar next year as being closely linked to President Trump getting his tax cut plans through Congress. Loosening fiscal policy at this stage of the cycle would add to the case for monetary tightening and likely see markets price in even more rate hikes.

Furthermore, if there is also a one-off, additional cut to corporate tax in an amnesty to entice back profits held by US corporates overseas, as is being mooted, then this also should trigger dollar gains. US companies are likely to have to move some funds into dollars to repatriate them.

However, the dollar is not a one-way bet against the euro. If inflation remains subdued in the US, the Fed may not tighten policy as much as it has indicated. The Fed has been guiding that rates are likely to rise to 2.75% by end 2019, but continuing low inflation would throw this into doubt.

It should also be noted that despite its rise this year, the euro is still at a relatively low level against the dollar. EUR/USD generally traded in a $1.20-1.50 range from 2003 to 2015. At some stage, it is likely to return to this level.

Indeed, we have seen the euro rise from $1.16 to above $1.19 in the past three weeks as some key Fed members expressed concerns about the persistence of low inflation. Thus, it is all to play for in forex markets. We think that the dollar has upside potential in 2018 if President Trump can get his proposed tax cuts implemented and the Fed continues to steadily hike rates.

Oliver Mangan

Chief Economist

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