High US rates to underpin strong dollar

The Russian invasion of Ukraine triggered a further bout of dollar strength this spring, in terms of a flight-to-quality into the world's largest reserve currency. The fact that the Fed has also been the most aggressive of the main central banks in raising rates, with two 75bps hikes in the past two months, further boosted the US currency over the summer. Indeed, the dollar has now risen to its highest level in twenty years on a trade-weighted basis, making significant gains this year against a broad range of currencies, including the yen, sterling and the euro.

Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under pressure following the invasion of Ukraine and the imposition of sanctions on Russia. It was trading at $1.15 before the Russian invasion, before falling to parity in the summer, its lowest level against the dollar since 2002.

It is difficult to envisage a significant fall in the dollar over the balance of the year as it should be supported by a continued move upwards in US interest rates to circa 3.5%, as well as relatively high US bond yields. Markets could also remain volatile, leading to more flows into traditional safe-haven currencies like the dollar. Geo-political risks are also likely to remain elevated, which should be supportive of the US currency.

From a euro viewpoint, the fact that the ECB is set to deliver further rate hikes over the remainder of 2022 should prove beneficial for the currency. However, the war in Ukraine is likely to continue to pose a risk for the euro, especially if there are further major interruptions or a complete cessation of gas supplies from Russia. This could lead to gas rationing and power cuts in the Eurozone this winter, with the accompanying increased risk of a recession as output declines.

This would likely put renewed downward pressure on the single currency. Should parity give way, then a decline to $0.95-0.96 could be on the cards against the dollar. The last time that the euro dropped below parity, it spent almost three years there over the period 2000-2002. Our base case, though, is that the ending of negative interest rates and further ECB rate hikes will help put a floor under the single currency. Market positioning is also very long the dollar at present, which should limit its upside.

Indeed, we saw the dollar lose some ground last week on the back of better than expected US inflation data, with the headline CPI rate dropping from 9.1% to 8.5%. This saw the euro climb to around the $1.03 level. However, we don't think the Fed will be easily dissuaded from delivering further significant rate hikes over the balance of the year, with inflation still so elevated. Thus, while the dollar may be showing signs of peaking, we expect it to remain at a high level in the coming months. That is unlikely to change until US rates reach a peak and policy easing is seen coming on to the Fed's agenda. This is not expected to happen until well into next year.

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