USD Bear Run Set To Extend Through End Of 2019

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We maintain a bearish USD outlook on the basis of cyclical, structural, and secular trends. The outlook for relative central bank policy has reached its climax in terms of offering the USD support, and widening fiscal and current account deficits are expected to deliver medium-term weakness in the currency. Longer-lasting secular trends also appear to be bearishly aligned, given the USD's 2017 turn marking the end of its post-crisis rally.

The Fed has signaled a pause in further rate increases, reflecting concerns over tighter financial conditions and softer global growth. The 2016 episode has been referenced, a year in which the Fed capitulated to markets and shifted from its intended four-hike path to one 25bpt hike in December of that year. Policymakers on the Board of Governors are now broadly neutral and regional presidents' equivocation on rates clearly reveals the dove (Bullard, Bostic) / hawk (Evans, Rosengren) divide.

The global growth outlook is indeed awful—at the moment—reflecting trade-war driven weakness in China and Germany. However, the tenor of trade negotiations appears to have improved and talks between the U.S. and China are ongoing. China's policymakers are stimulating their domestic economy in order to offset trade-related headwinds, opening up the risk of a pickup in growth in the coming months. The ECB is also taking a measured approach to rate normalization while signaling ongoing confidence in their forecast for steady, above-trend growth.

Ultimately, we look to a narrowing in growth differentials between the U.S. and its developed economy peers as the effects of U.S. fiscal stimulus fade and other economies recover from their 2018 soft patch. These developments should erode the USD's supportive growth and interest rate differentials.

An improvement in the outlook for global growth is typically USD-negative (reflecting the middle of the USD 'smile') as investment flows migrate to out of safer, USD-denominated assets into higher-risk securities. Indeed, we've observed relative outperformance in emerging market and European indices relative to North American benchmarks in the period since October 3rd. Shifting global portfolio investment flows will pose a challenge for the USD as fiscal deficits remain relatively wide on a cyclically-adjusted basis.

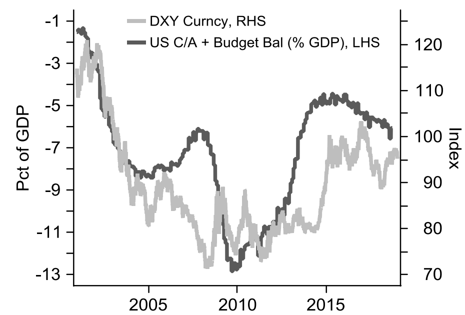
U.S. political developments remain a negative for the USD as the government shutdown extends into mid-January. Currency markets also remain attuned to headlines relating to the Mueller investigation.

Technically, the USD reached a high in mid-December, just ahead of the Fed's 25bpt hike. The subsequent decline has been relatively swift, reflecting material weakness vs. all of the G10 currencies as well as MXN, BRL, and CNY.

Weekly speculative positioning data have not been released since the start of the U.S. government shutdown. The last report, released December 21, revealed bearish positions in nearly all of the reporting currencies (vs. USD) and sizeable shorts in the G3 (JPY, EUR, GBP). The recent turn in the USD has likely been exacerbated by extended bullish USD positioning.

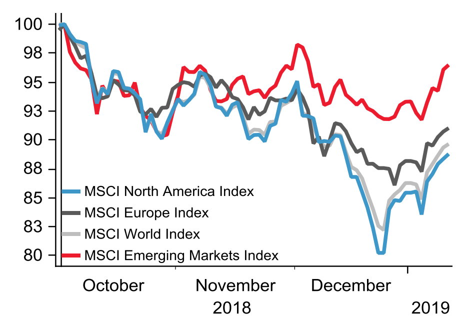
We continue to feel that 2017 marked a turning point for the USD, ending a multi-year bull run that began in the aftermath of the financial crisis. These alternating USD cycles typically last around 8 years in length and we suspect that the USD's 2018 gains reflected a counter-trend move in the context of a secular bear run. In terms of our FX forecast for Q4 2019, we have USDCAD softening to 1.27, EUR climbing to 1.30, GBP rallying to 1.40 and AUD recovering to 0.78.

US Twin Deficits A Concern For The USD



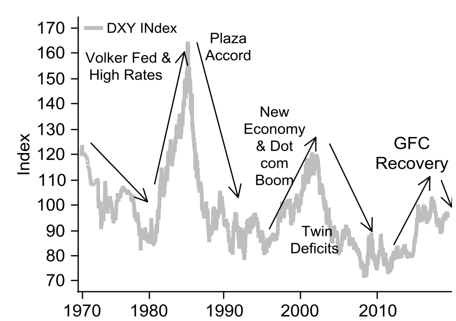
Source: Macrobond, Scotiabank FICC Strategy

Global Equity Indices Rebased To October 3



Source: Macrobond, Scotiabank FICC Strategy

DXY Bull/Bear Phases Last ~8 Years



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