Dollar Won’t Be Haven Currency of Choice for Long: Trader Talk
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By Vassilis Karamanis
(Bloomberg) -- When the pandemic rattled global markets back in February 2020, traders made an initial run for the safety of the yen. It wasn’t long before investors went the other way, flipping their exposure and going bullish the dollar. And while the Japanese currency remained better bid across the board for a few months, the greenback claimed the haven currency of choice throughout 2021 and enjoys similar momentum this year, especially against the yen. However, a turning point may be near.
* And it will mostly have to do with whether we have reached a peak-inflation point. This is arguably the most crucial question for markets at this point. Geopolitical concerns, although present and solid, are flying relatively low on investors’ radars, and will continue to do so until the next big headline hits the wires. There are various inflationary mechanisms at work currently, according to Sebastien Galy, macro strategist at Nordea Investment Funds SA: wage spirals, the war in Ukraine and the risk of a natural gas embargo, and commodity prices. Galy argues that it’s unlikely inflation can stay elevated for long without a recession or a policy mistake by the Fed.
* For the euro area, he says that the peak of inflation is very close as “an ageing population and the rapid transformation of mature sectors eventually are likely to prove deflationary.” Overall, Galy expects inflation to peak this year globally, and that we should see “demand rebound leading to a recovery in earnings and fixed income” yet we aren’t there yet as central banks are tightening. The key problem for Europe though is that a temporary natural gas embargo by Russia is increasingly likely over the winter as it loses the battle of logistics and production.
* Some pieces of data send an alarming tone. Germany’s PMI new export orders are at the lowest in two years, China’s gauge paints a similar picture, while financial conditions in the U.S. were tighter than average for the given growth and inflation in the U.S. in the week ending April 29, based on the Chicago Fed adjusted national index. Which raises the question whether money market wagers are too aggressive, looking for three consecutive 50-basis-point interest rate increases by the Federal Reserve

and almost four 25-basis-point hikes by the European Central Bank by year-end.
* This in turn takes us to an interesting observation by George Saravelos, Deutsche Bank AG's global head of currency research, who says that "we are perhaps now reaching the tipping point where further financial conditions tightening will start to place more severe headwinds to how much more we can reprice the Fed." This will result in the dollar becoming less responsive to risk-off due to more dovish implications for the Fed path. And while it's still early stages, Saravelos argues that "the market is starting to behave as if we may be approaching this tipping point."
* Now, even if inflation does peak this year, that won't mean central banks will exit their tightening path, but will adjust it accordingly. Just look at the Bank of England's latest forward guidance and the divide within the voting committee. At the same time, and if we talk stagflation or recession, we should consider that the yen may attract haven flows once again given its low inflationary readings, Japan's current surplus and so forth.
* The currency market tends to be noisy and a retreat in the dollar may not be attributed to that tipping point mentioned earlier if risk-off sets the tone. Profit taking, position rebalancing, a healthy correction, "whatever has a position on will get hurt," are all possible narratives that may be used by analysts and traders alike. Options may be the way once again, and a reversal in long-term wagers is what could give us a definitive signal that something is changing when it comes to the greenback and haven flows.
* One-year risk reversals in the Bloomberg Dollar Spot index show that the topside trades at triple the past five-year average as demand for bullish bets has dominated since August 2020. After all, the gauge has been in negative correlation with the S&P 500 within this period, so any change there could signal that one of the tailwinds for dollar-long exposure is fading.
* For now, the U.S. currency remains king with rallies in the euro and the pound seen as great opportunities to enter the long-dollar trade from more favorable levels. But for how long can one keep such a position if the U.S. enters recession mode? Minneapolis Fed President Neel Kashkari wrote Friday that if the supply-chain disruptions don't resolve soon, the Fed may be forced to spur a recession. And then haven flows will no longer support the greenback.
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