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Dollar-o-meter: There's some 2018 in the air

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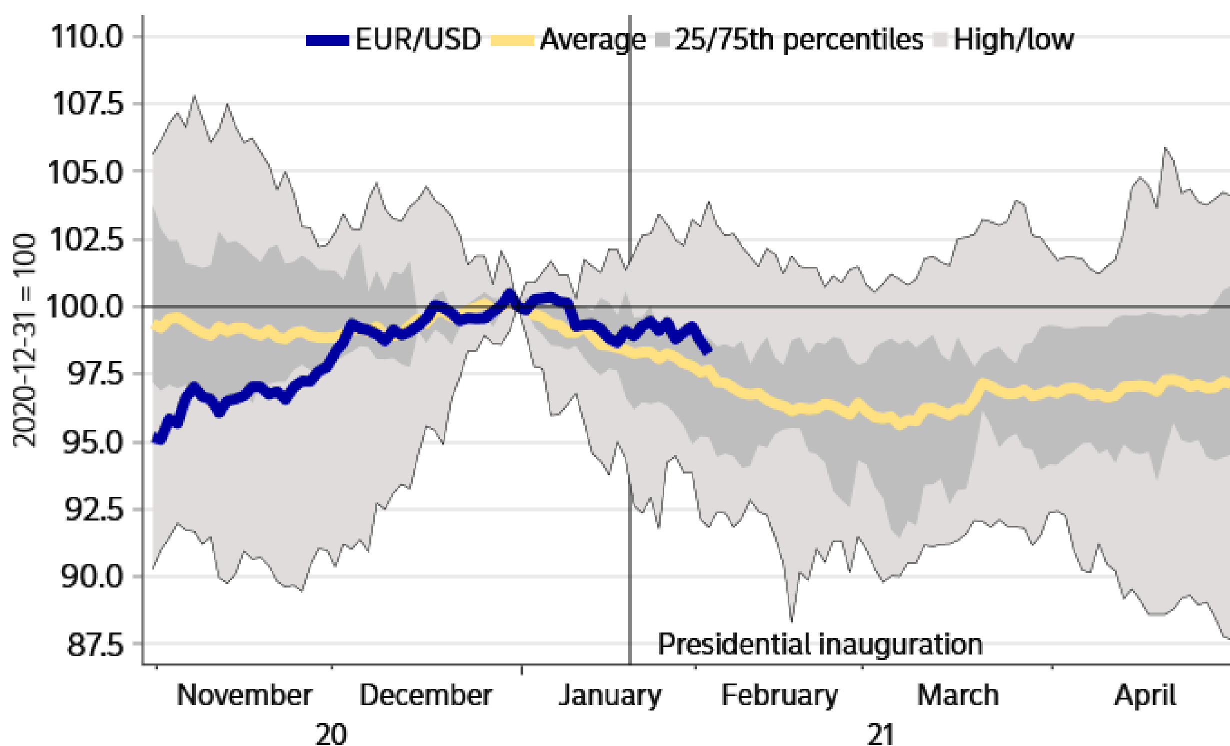
The dollar-o-meter framework includes growth, inflation, central bank policy, politics, as well as thoughts on the dollar smile. From this update, we see greater upside risks for the dollar than generally appreciated.

The consensus trade of a higher EUR/USD in 2021 has so far failed to materialise. Instead, the pair seems to be repeating its usual post-election or post-inauguration patterns and head lower instead.

Chart 1: EUR/USD usually drops after Presidential inaugurations



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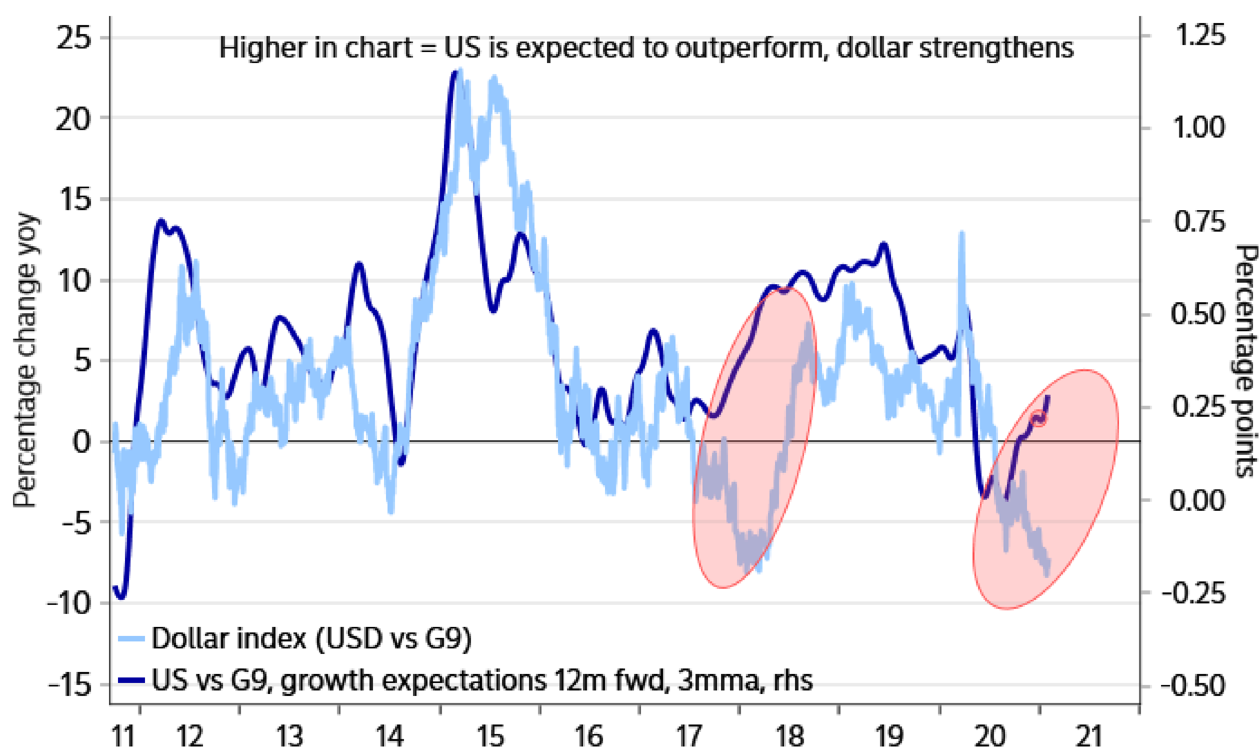
To see what the future may bring, we revisit our dollar-o-meter framework, which examines the following factors: relative growth, relative inflation, relative central banking policy, and politics. We also incorporate the dollar smile theory into our analysis.

We find that relative growth, relative inflation, relative central banking policy, all favour the USD. The political outlook and the dollar smile appear more negative, but primarily from a structural / medium term perspective. We therefore stick to our view that **the USD is at risk of wrong-footing the consensus once more**, and strengthen rather than weaken in 2021.

Growth

US growth expectations have been climbing vs an equal-weighted basket of growth expectations for the other G10 currencies. And has managed to tick higher in the most recent outcome also vs the EUR.

Chart 2: Relative growth look supportive of the USD



We think Biden will be able to launch a substantial stimulus package in contrast to eg the Euro-area or the UK where nothing is planned or where even tax hikes are mulled. Indeed**, the last time we saw the dollar weaker in yoy terms despite a robust pick-up in growth expectations was in the early parts of 2018**, and we know what happened then.

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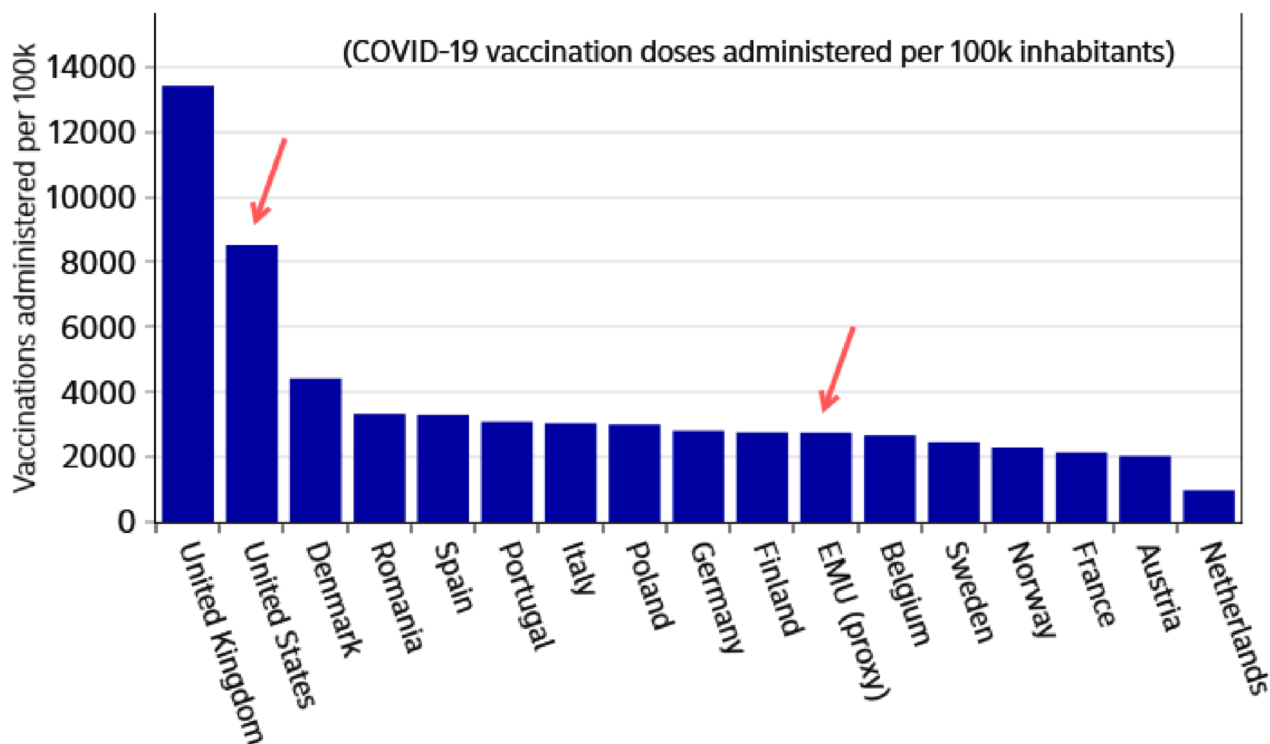
Chart 3: If Trump failed, what did vdL do?



What's more, the US is well ahead of the EA in terms of getting its population vaccinated (perhaps Trump admin failed in 2020, but then van der Leyen (vdL) failed even worse). This augurs earlier reopening in the US than in the EA, which favours US growth. What's more, **the weaker USD seen in 2020 (1.07 -> 1.23) augurs US manufacturing outperformance** over the next couple of quarters.

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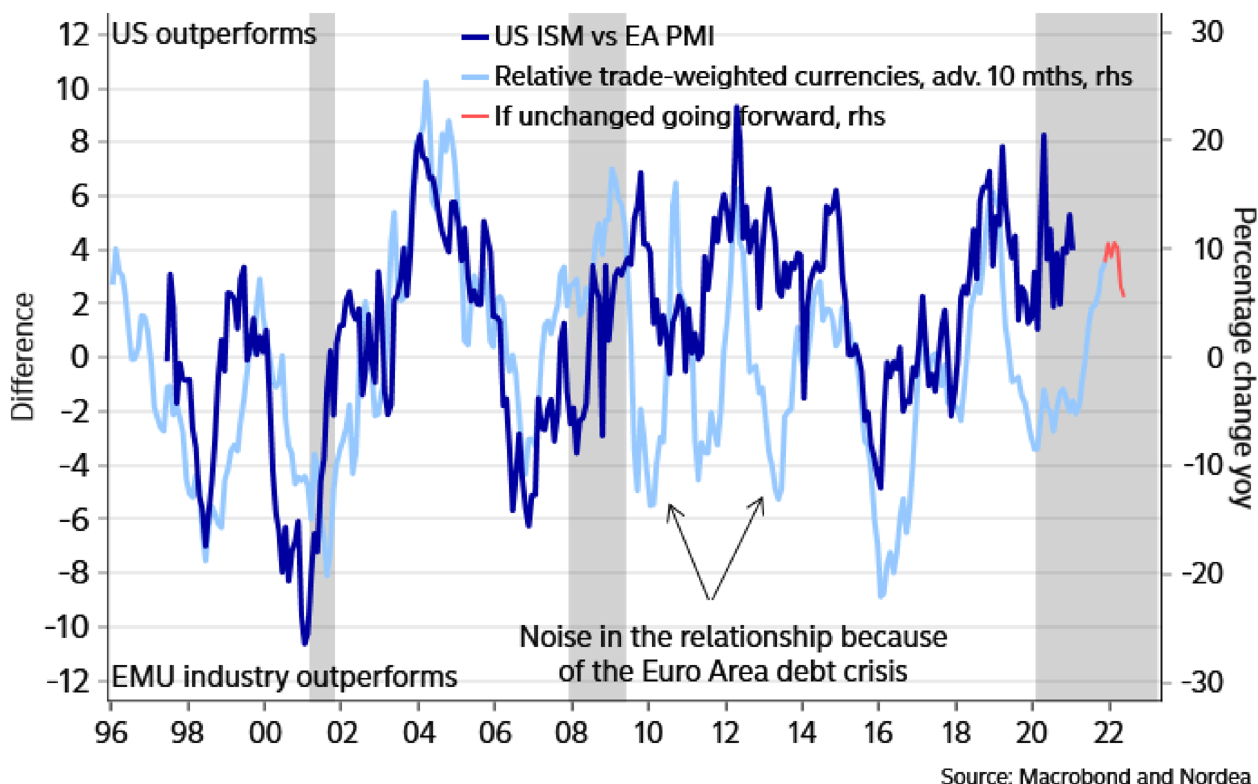
Chart 4: FX impulse should translate to ISM outperforming PMI



In short, we see three reasons to expect US growth expectations to climb vs the EA: i) fiscal divergence, ii) the financial impulse from 2020 and iii) vaccine divergences.

=> We are thus more convinced about the upside risks to US growth expectations than for the EA, which should be helpful for the USD.

Inflation

While inflation is generally considered a negative driver for currencies, higher inflation can, counterintuitively, have a positive impact on the currency - if it pushes central bank pricing in a more hawkish direction. Indeed, **over the past decade, relative core inflation developments have helped predict the direction of the EUR/USD** (after some delay).

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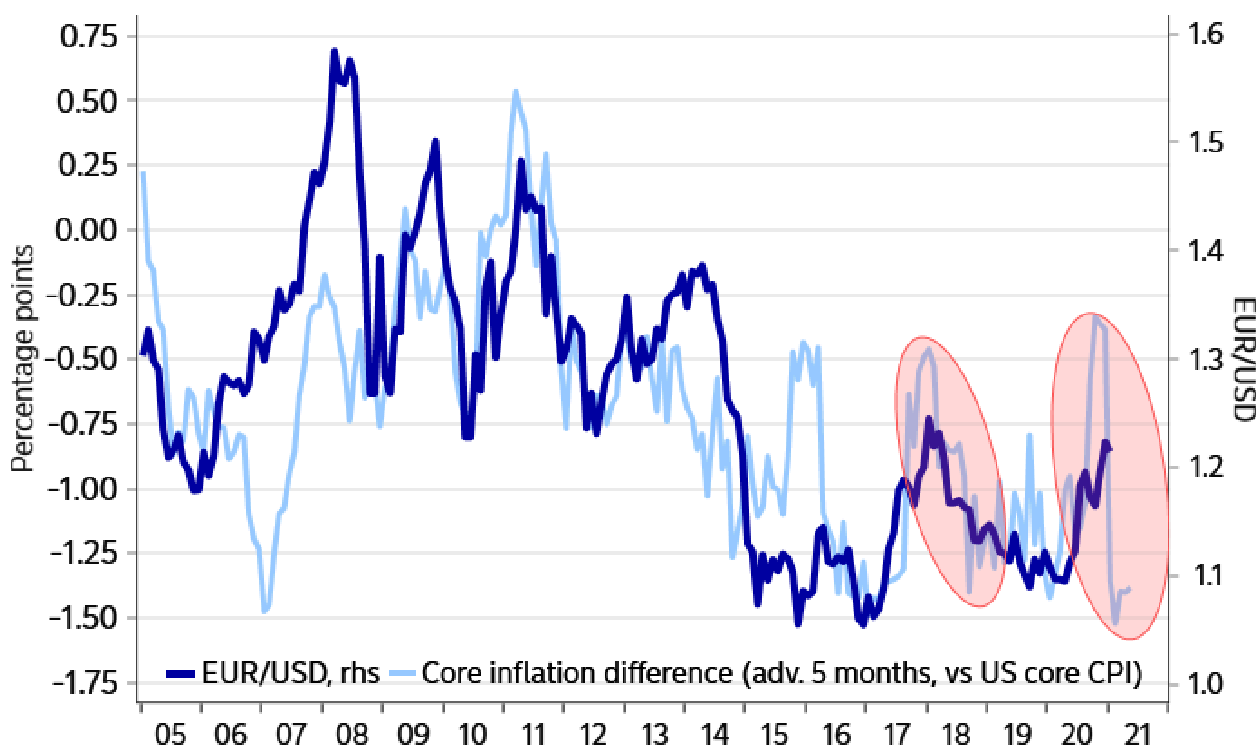
Chart 5: Relative inflation currently point south for EUR/USD



US core inflation has most recently topped expectations three times in a row. This is positive news for the USD, especially since our models suggest that a further acceleration in US core inflation may be on the cards. (gasoline prices vs core inflation) Indeed, **the last time relative inflation had climbed in relative terms just as it has done recently again puts us back in the early parts of 2018.**

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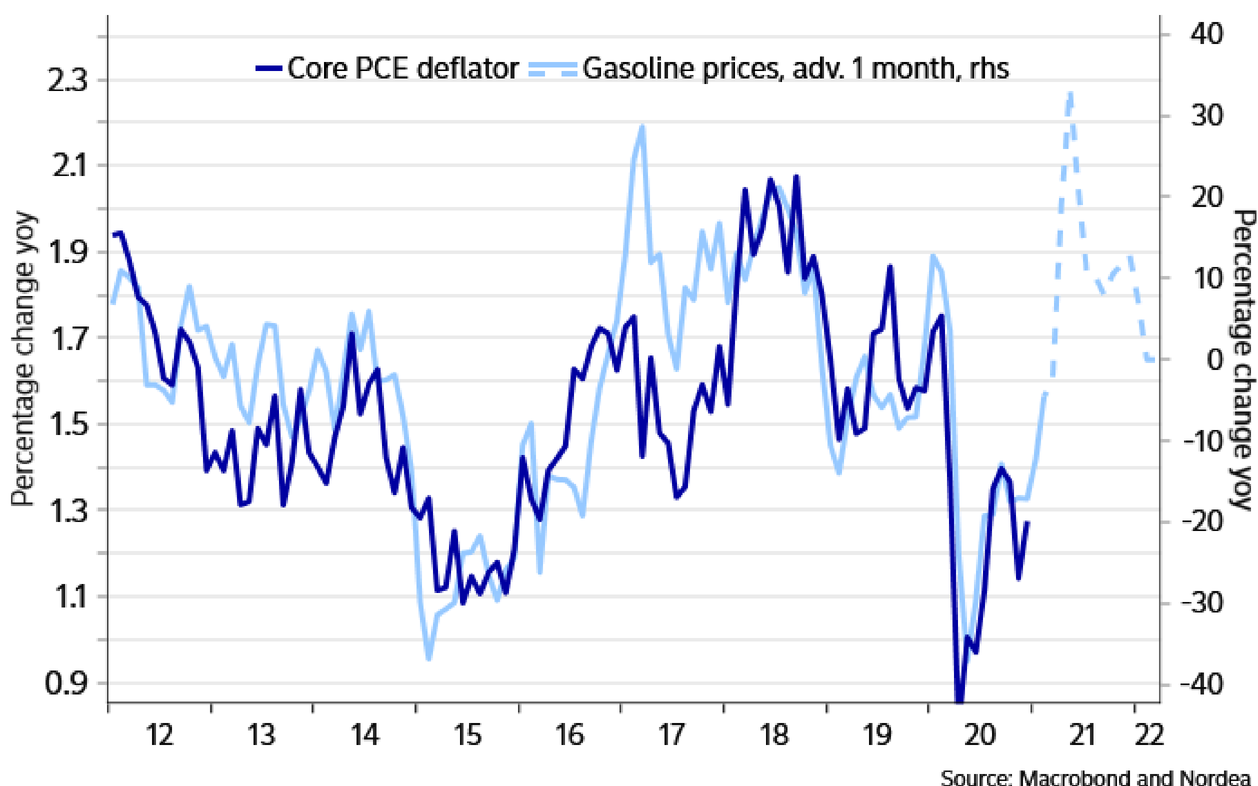
Chart 6: Core inflation vs US gasoline prices (if unchanged)



Looking ahead, base effects from higher oil prices ought to push headline CPI inflation to 2.5% or higher. More interestingly, we also see upside risks to core inflation stemming from unforeseen spill-over effects from energy prices. For instance, gasoline prices in year on year terms show a decently strong correlation (0.75 since 2012) with core PCE inflation, even though they shouldn't. What's more, the **corporations which survived the 2020-21 lockdowns will have greater pricing power, suggesting that inflation may rise even without higher input costs**. But insofar costs are concerned, we also note that the US is highly likely to close its output gaps earlier than the Euro-area - suggesting more inflation in the US, earlier, than in the EA.

=> We are more convinced about the upside risks to US inflation than for EA inflation, which should be helpful for the USD.

Central bank policy

It's one thing to say you will accept inflation overshooting, it's another thing to do it once inflation is decidedly overshooting - especially with global growth numbers booming at the same time. We therefore expect the market to be back in questioning the pace of the Fed's bond purchase program around summer at the latest (the consensus looks for the first tapering some time in H1, 2022 - too late in our view). **A further sell-off in US fixed income, or steepening of US curves in relative terms, will at least reduce the downward pressure on the dollar** from a double deficit perspective. It will also weigh on various "fair value" models for the EUR/USD.

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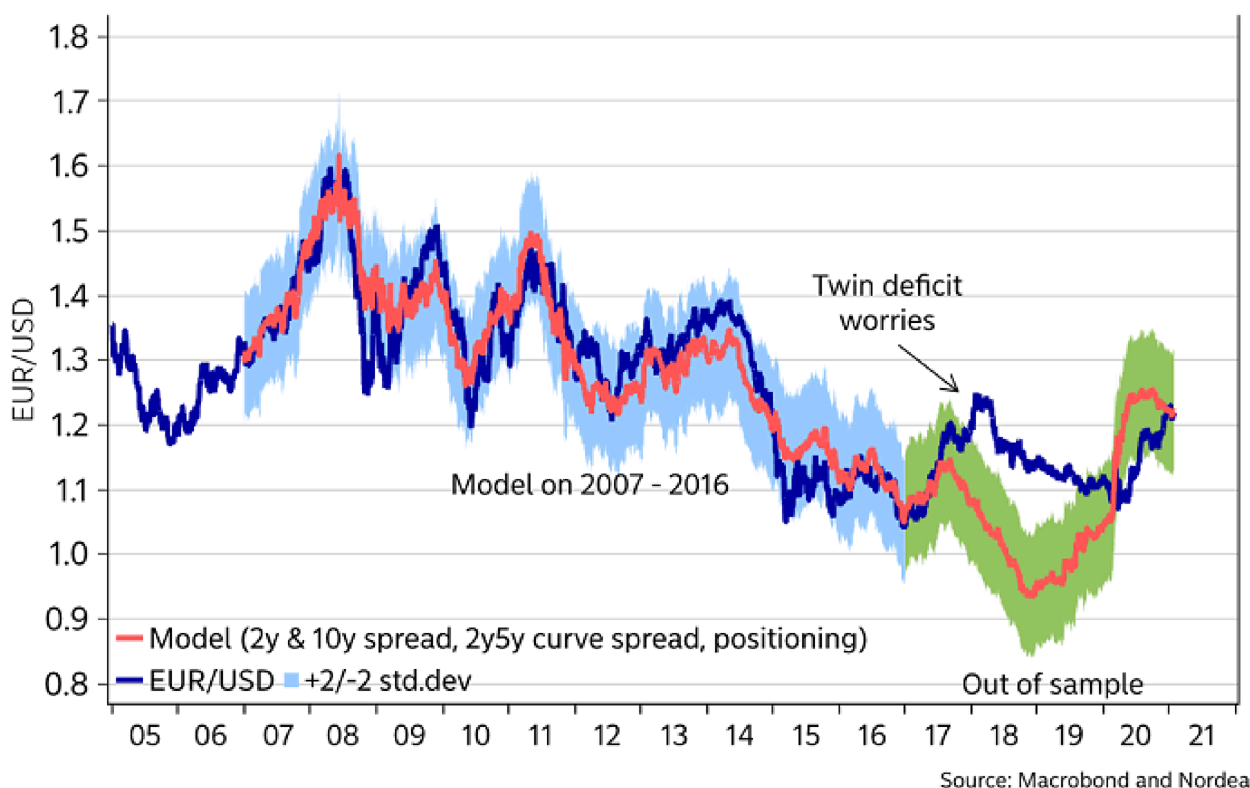
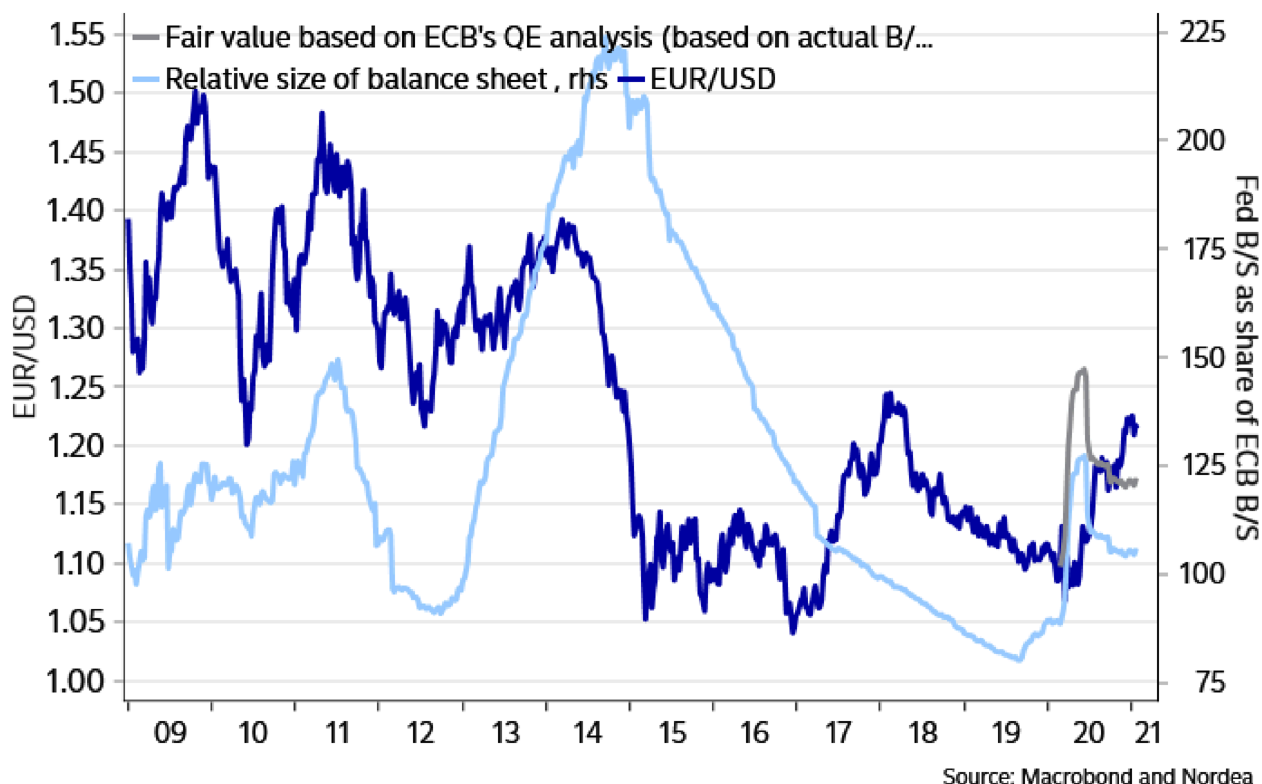
Chart 7: Fair value for EUR/USD based on relative rates, curves and positioning



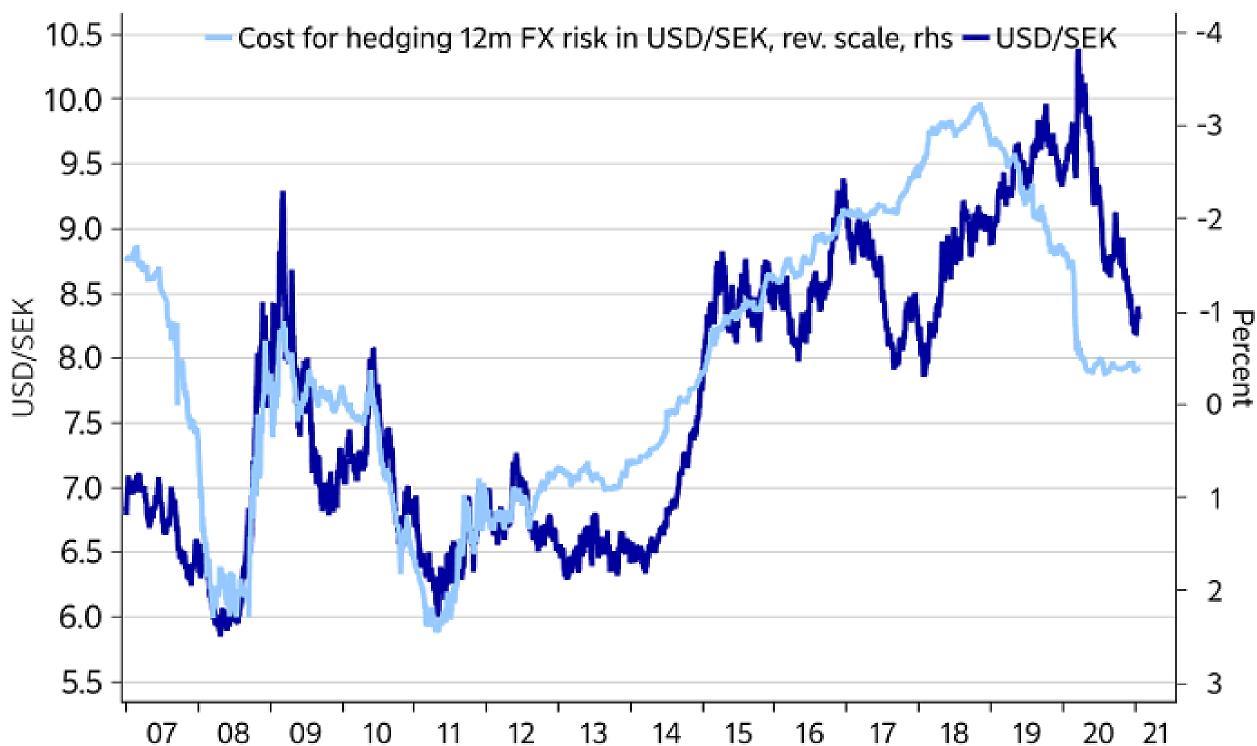
What's more, the **ECB's own research suggests the relative size of central bank's balance sheet has an impact on the EUR/USD exchange rate.** Based on the ECB's approach and estimates in October 2020 we can calculate a QE-derived fair value for the EUR/USD exchange rate. Basing our calculations on realised balance sheet developments, we can calculate the current "QE fair value" of the EUR/USD to have dropped(!) from the summer of 2020 when it peaked above 1.25 to currently reside in the 1.17 area**. Even if the Fed does not taper earlier than anticipated, which could be good news for the USD, perhaps Mrs Lagarde has a trick or two up her sleeve to undermine the EUR?**

Chart 8: Fair value for EUR/USD based on ECB's research



Finally, the Effective Fed Funds Rate recently traded at its lowest level since June 2018. With a surge in liquidity imminent as a result of the US Treasury's plans to bring the TGA cash balance towards USD 500bn by summer, the downward pressure on the EFFR will increase. This could in turn prompt the Fed to hike ON RRP or the IOER rate, so as to keep the EFFR close to the middle of its target interval. While not a biggie, it would possibly underpin the USD psychologically.

Chart 9: USDSEK 12m hedging costs



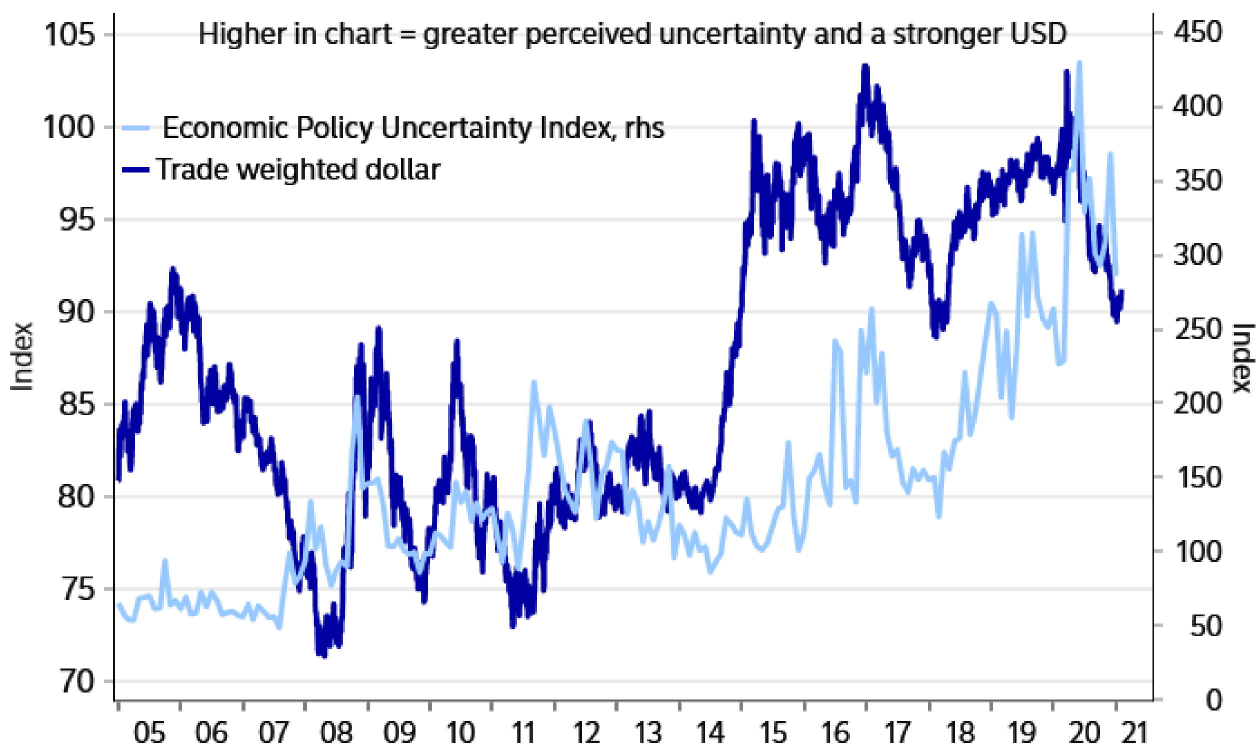
What's more, we judge it is **more likely that the Fed will be earlier than the ECB (or the Riksbank) in pondering new rate hikes.** This will at some point make selling the USD costlier. We predict the first Fed hike by the end of 2022.

=> We judge the relative central bank outlook to be favourable for the USD.

Politics

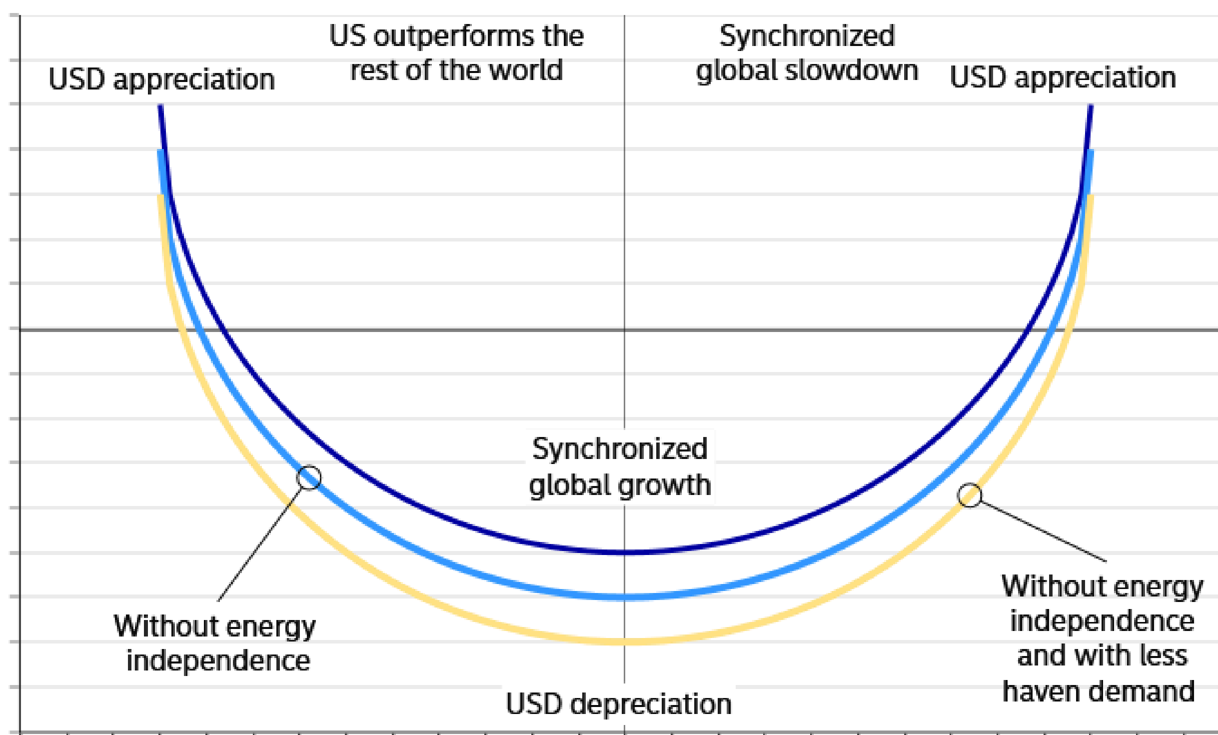
On the political front, the outing of the "Mango Mussolini" from the White House to be replaced with "Beijing Biden" is widely seen as lowering global economic-political uncertainty. And we largely agree. That said, we suspect the new US administration could be more eager to start new wars, since that is what all other Presidents but Trump since 1980 has done. Nonetheless**, lower uncertainty will generally be seen as bad news for the dollar.**

Chart 10: Elevated uncertainty good news for the trade-weighted USD



From a structural point of view, the new President's energy policies will likely make the US less self-sufficient. This may augur a structural shift down in the dollar smile - as the US will export more dollars via a larger current account deficit than otherwise. This point may also underpin the "need" for the US to become more interventionist abroad so as to be able to guarantee oil imports. The new President also seem likely to re-regulate the economy, which could have negative medium-term consequences for US growth, which would in turn skew the dollar smile to the detriment of the USD.

Chart 11: The dollar smile could shift lower owing to Biden's policies



The weaponisation of the US-dominated financial system (such as shutting out of Iran from the SWIFT international payment network) also seems likely to reduce demand for the USD and US Treasuries as safe havens in the years to come, which could also augur a shift lower (or skew) to the dollar smile as far as the upside in the USD is concerned. However most of these "political drivers" are medium-term or long-term drivers, which means that we should weigh them down accordingly when thinking about 2021.

=> We nonetheless judge the outlook for politics and uncertainty as generally negative for the dollar, especially for the medium and long terms.

Summing up...

To sum up our findings, we argue that **relative growth, relative inflation, and relative central banking policy will tend to favour the dollar in the quarters to come**. It's primarily the shift lower or the skew in the dollar smile which argues otherwise. Therefore, we stick to our out-of-consensus view that **EUR/USD will end the year lower compared to where it started the year.**

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