J.P.Morgan
Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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USD strikes back

The US dollar has seen a powerful resurgence in recent weeks. Can its strength persist?

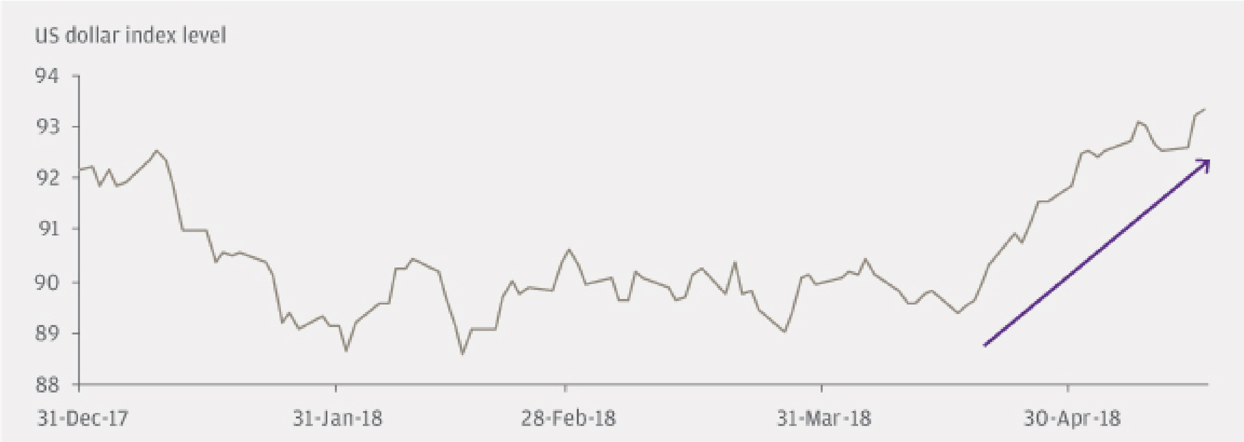
Fundamentals:

Recent economic data releases suggest the softness earlier this year was a slowdown in momentum rather than a reversal in growth trends, particularly in the US. For instance, US consumer sentiment remains robust and April retail sales data showed broad-based improvement. Not only is this stronger data creating positive surprise momentum in the US, but our proprietary economic expectation models also indicate that economists' forecasts for future releases are trending upwards. The April US inflation print was lower than expected at 2.1% year on year, though the underlying composition was more favourable, with shelter prices registering a moderate rise. We do not expect this release to derail the Federal Reserve from its current gradual rate hiking path, but it provides little impetus for more aggressive policy. Although we also retain our conviction in the European economy, the divergence in data releases between the two regions has become increasingly apparent—with consequences for the currency market.

Quantitative valuations:

After a challenging start to the year, the US dollar index (a measure of the average exchange rate between the dollar and other major currencies) has appreciated sharply in recent weeks, moving 1.7% stronger month to date and more than 5% higher since its low point of the year in February. One of the most closely watched currency pairs, EURUSD, has shown a similar trend: after trading in a tight range throughout February and March, the euro has lost more than 4% vs. the US dollar since 31 March. Part of this move can be attributed to developments in the rates space, as US 10-year Treasury yields have broken through the important technical level of 3.05% and are now a meaningful 69 basis points (bps) higher year to date—compared to German 10-year Bund yields, which are just 18 bps higher over the same period. (All data to 16 May).

The US dollar index has appreciated sharply in recent weeks, recouping its losses from earlier this year



Source: Bloomberg; data as of 16 May 2018.

Technicals:

Surveys of investor positioning in the US dollar are providing mixed signals, though overall they have moved less short, in line with the currency's recent strength. Euro positioning is less clear: one survey indicates a move from long to neutral, while another suggests that positioning is still as long as it has been for the majority of this year. Importantly, we have not yet seen evidence of any reallocation by reserve currency managers from US dollars to euros—something we had expected given the view that the US may be abusing its status as a reserve currency by announcing significant fiscal spending plans.

What does this mean for fixed income investors?

We believe there is scope for the US dollar's march higher to persist, though there is some nuance to this view. The higher yields offered by the US market, particularly vs. markets historically viewed as having "carry currencies", such as Australia, should lead to US dollar strength relative to those currencies. Our expectation for long-end yields in the US to continue their move higher—with 3.25% the next likely target on the 10-year—is also US dollar-supportive. However, the US's twin deficit remains a compelling argument for relative outperformance of the euro vs. the US dollar over the longer term; it will be key to monitor whether flows by reserve currency managers start to validate this view. For the euro to regain strength over the US dollar, though, there will need to be signs of life in eurozone inflation, keeping the European Central Bank on its path of tapering asset purchases.

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