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Dollar weakness to pressure other central banks

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- The dollar has fallen sharply across the board, but in particular against the euro and the yen
- This reflects concerns about the US economy and the scaling back of Fed rate hike expectations
- The weakness in the dollar, and hence strength in the euro and yen, puts pressure on the ECB and BoJ to ease further
- Meanwhile, the BoE looks set to sit on its hands in 2016 – we shift our call for the first rate hike from 2016Q4 to 2017Q1

US economy worries lead to dollar slide

The weaker-than-expected US economic numbers earlier in the week (the Markit services PMI and ISM non-manufacturing) have caused a dramatic sell-off in the US dollar. This reflects that the data fueled concerns about the economic outlook and led markets to further scale back Fed rate hike expectations. EUR/USD broke through 1.12, while it began the week at 1.0830. At the same time, the USD/JPY dropped to lows below 117 thereby fully erasing the weakness in the yen after the BoJ decision last week.

US Dollar Trade Weighted Index



Source: Bloomberg, ABN AMRO Group Economics

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The ball is now back in the court of the ECB and the BoJ. The resulting stronger euro and yen will tighten financial conditions and dampen growth and inflation in these economies. With inflation already uncomfortably low in both economies, we would expect the central banks to react to offset the headwinds from a stronger currency. We expect the ECB cut its deposit rate in two steps (March and June) to -0.5% and to increase its asset purchase program by 10bn in March. The risks are also skewed to more aggressive monetary stimulus. Meanwhile, we think the BoJ will also cut its policy rate further into negative territory in the coming months. In this way the currency tennis between the central banks is leading to easier policy globally.

Monetary policy divergence story still holds

It is likely that in the near-term, currency markets remain biased towards softer US economic data and therefore the downward pressure on the dollar will continue. Our base case is that the Fed will resume its 'rate hike cycle' in June, though the risks are indeed skewed towards an even longer period where the policy rate is kept on ice. However, even if this is the case, with the ECB and BoJ going potentially more aggressively in the other direction, the monetary policy divergence story remains in place. We therefore expect the EUR/USD to fall back again in the medium term. An improvement in investor sentiment is a pre-requisite though.

Change of BoE view: no hikes until 2017

Following the BoE's communication on Thursday, we now expect that there will be no UK rate hikes in 2016. We have changed our forecast for the first rate hike to February 2017 from November 2016 previously. We assume there will be four 25bp hikes in all next year. This forecast change has been increasingly on the cards over recent weeks given the worsening growth and inflation outlook. The MPC confirmed this deterioration in its Inflation Report, where it cut its projections. Its new lower projections imply that the BoE will likely not need to move until next year. This would give the economy more support and allow inflation to move back up to target over the next two years. The unanimous vote to keep rates on hold on Thursday – with the MPC member who previously voted for a hike dropping his call – is also a signal that rates will be on hold for longer.

Day	Date	Time	Country	Key Economic Indicators and Events	Period	Latest outcome	Consensus	ABN AMRO
Monday	01/02/2016	02:00:00	CN	PMI manufacturing - index (official)	Jan	49.4	49.6	
Monday	01/02/2016	02:00:00	CN	PMI non-manufacturing - index (official)	Jan	53.5		
Monday	01/02/2016	02:45:00	CN	PMI manufacturing - index (Caixin)	Jan	48.4	48.1	
Monday	01/02/2016	09:00:00	NL	PMI manufacturing - index	Jan	52.4		53.2
Monday	01/02/2016		EC	PMI manufacturing - index	Jan F	52.3	52.3	
Monday	01/02/2016	10:30:00	GB	PMI manufacturing - index	Jan	52.9	51.8	
Monday	01/02/2016	14:30:00	US	PCE deflator core - % mom	Dec	0.00	0.11	
Monday	01/02/2016	14:30:00	US	PCE deflator core - % yoy	Dec	1.4	1.4	
Monday	01/02/2016	15:45:00	US	Markit - Flash PMI	Jan F	52.4		
Monday	01/02/2016	16:00:00	US	ISM manufacturing - index	Jan	48.2	48.4	48.0
Monday	01/02/2016	19:00:00	US	Fed's Vice-Chair Fischer speaks on economy and policy				
Tuesday	02/02/2016	06:30:00	IN	Repo rate - %	Feb 2	6.75	6.75	6.75
Tuesday	02/02/2016	09:55:00	DE	Unemployment - %	Jan	6.2	6.3	
Tuesday	02/02/2016	09:55:00	DE	Unemployment change - thousands	Jan	-20.0	-7.3	
Tuesday	02/02/2016	11:00:00	EC	Unemployment - %	Dec	10.40	10.50	
Wednesday	03/02/2016	02:45:00	CN	PMI services - index (Caixin)	Dec	52.4		
Wednesday	03/02/2016	02:45:00	CN	PMI composite - index (Caixin)	Dec	50.1		
Wednesday	03/02/2016	10:00:00	EC	PMI services - index	Jan F	53.6	53.6	
Wednesday	03/02/2016		EC	Composite PMI output	Jan F	53.6	53.5	
Wednesday	03/02/2016	10:30:00	GB	PMI services - index	Jan	55.6	55.4	
Wednesday	03/02/2016	11:00:00	EC	Retail sales - % mom	Dec	0.3	0.3	0.5
Wednesday	03/02/2016	14:15:00	US	ADP nat. employment report - thousands	Jan	205.0	199.9	180
Wednesday	03/02/2016	16:00:00	US	ISM non-manufacturing, index	Jan	53.5	55.2	55.0
Wednesday	03/02/2016		PL	Reference rate - %	Feb 3	1.5		
Thursday	04/02/2016	13:00:00	GB	Policy rate - %	Feb 4	0.5	0.5	
Thursday	04/02/2016	13:00:00	GB	BoE size of asset purchase programme - GBP bn	Feb	375.0	375.0	
Thursday	04/02/2016	13:00:00	CZ	Repo rate - %	Feb 4	0.1		
Thursday	04/02/2016	14:30:00	US	Output per hour nonfarm business sector - % qoq	4Q P	-3.0	-1.4	
Thursday	04/02/2016	20:00:00	MX	Policy rate - %	Feb 4	3.3		
Friday	05/02/2016	08:00:00	DE	Manufacturing orders - % mom	Dec	1.5	-0.2	-1.0
Friday	05/02/2016	09:00:00	CH	Foreign currency reserves - CHF mln	Jan	559682		
Friday	05/02/2016	14:30:00	US	Change in employment private employment - thousands	Jan	275	199	180
Friday	05/02/2016	14:30:00	US	Change in employment total - thousands	Jan	292	204	190
Friday	05/02/2016	14:30:00	US	Unemployment - %	Jan	5.0	5.0	5.0
Friday	05/02/2016	14:30:00	US	Trade balance - USD bn	Dec	-42.4	-42.5	
Friday	05/02/2016	21:00:00	US	Fed Reserve consumer credit - USD bn	Dec	14.0	14.8	

Source: Bloomberg, Reuters, ABN AMRO Group Economics (we provide own forecasts only for selected key variables and events)

Find out more about Group Economics at: <https://insights.abnamro.nl/en/>

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