CURRENCIES: EUR/USD

DON'T WRITE OFF THE ECB

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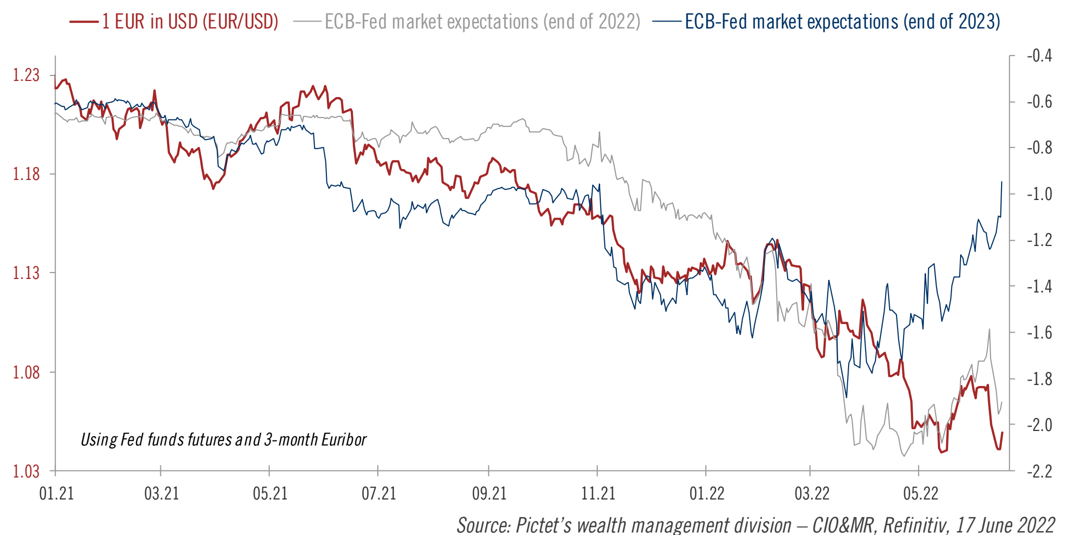
SUMMARY

- At USD1.05, the euro has come close to multi-year lows, reflecting increasing Fed rates, concerns about highly indebted European countries and rising energy prices.
- We are of the view that the European Central Bank will deliver a significant amount of rate hikes by the end of the year and that market fragmentation risks will be quelled.
- However, high energy prices are a clear threat to the euro because they hurt economic activity and the euro area's trade balance.
- We remain neutral on the euro in the short term (our three-month projection is USD1.06 per euro) but are more constructive in the medium term (our six and 12-month projections are USD1.11 and USD1.15, respectively).

Euro flirting with multi-years lows

The euro has been flirting recently with multi-years lows against the US dollar. To be fair, most of this decline is linked to the appreciation of the greenback, with strong US inflation in May leading to a sharp repricing of the path for Federal Reserve (Fed) rate hikes. The tightening in monetary conditions has weighed on risky assets and supported the safe-haven and increasingly high-yielding US dollar.

EUR/USD AND ECB-FED POLICY RATE SPREAD BASED ON MARKET EXPECTATIONS



Source: Pictet's wealth management division – CIO&MR, Refinitiv, 17 June 2022

Rate differentials unlikely to boost US dollar further

However, the European Central Bank (ECB) is now also signalling faster monetary normalisation, notably at its June policy meeting. Market expectations for ECB and Fed policy rates are sending mixed signals. While the yield spread for the end of this year has

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moved back in favour of the US dollar, it continues to improve for the euro next year (*see chart*). Market expectations are for around 175bp in additional rate hikes both in the US and the euro area in 2022 (both central banks have four meetings left this year). But the market expects the Fed to hike by only a net 10bp in 2023 (with the fed funds rate seen as peaking in May at around 3.9%) compared with around 100bp of net hikes for the ECB. Based on our new central scenario, we think it is more likely that rates will fail to meet market expectations in the US than in the euro area by the end of this year. The conclusion is reversed when we look at 2023. We acknowledge that expectations of significant tightening in the euro area in 2023 look quite optimistic, but the fact that the market is already pricing rate cuts by the Fed next year could be an offsetting factor. Overall, rate differentials are unlikely to be a particularly positive driver for the US dollar going forward in our view.

ECB will move to stabilise peripheral spreads

Despite the hawkish tone adopted at the ECB's June meeting, the euro fell. This was likely due to the lack of news on a credible backstop to limit the rise in borrowing costs facing heavily-indebted countries such as Italy as monetary policy is tightened. But this week's ad-hoc ECB meeting to discuss how to stabilise borrowing costs in weaker economies suggests that peripheral spreads are already close to the central bank's pain threshold. A new 'anti-fragmentation' tool seems likely to be formally announced at the next ECB Governing Council meeting on 21 July.

External shocks remain a clear threat

The rise in energy import prices stemming from the war in Ukraine and the drop in Chinese economic activity because of covid lockdowns have both weighed on the euro. While China's reopening reduces some short-term concerns about supply-chain disruptions and economic momentum, the euro area economy is faced with further rises in natural gas prices caused by US supply disruptions (a major terminal there will be offline for at least three months) and by Russian moves to diminish gas supplies to some European countries. Sustained high energy prices risk translating into higher living costs and weigh on the euro area's economic outlook. This could limit the ECB's ability to deliver monetary tightening and, coupled with a deteriorating trade balance, could lead to significant downward pressure on the single currency.

Improving market drivers versus worsening energy prospects

Nonetheless, we remain of the view that interest rate and growth differentials between the euro area and US should narrow, which should favour the euro relative to the overvalued US dollar. Furthermore, the end to negative interest rates and a credible mechanism to prevent market fragmentation could lead to significant improvement in net capital inflows into European debt securities. While we acknowledge that a marked slowdown in developed economies may keep the US dollar strong, expectations for rate cuts next year in the US could weigh on the greenback, especially if they support global risk appetite.

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We acknowledge that increasing geopolitical uncertainties could keep energy prices high and thus weigh further on the euro versus the US dollar in the short term and the credibility of ECB plans to tackle market fragmentation may be tested. But we are of the view that the ECB's scheme will prove robust and serve to quell concerns rapidly. Consequently, we remain neutral on the euro in the short term, with a three-month projection of USD1.06 per euro (with risk biased to the downside prior to the ECB's July meeting and to the upside afterwards). At this stage, we see limited reasons to change our more positive six-and 12-month projections (USD1.11 and USD1.15, respectively). The main risk to our constructive view on the euro comes from a sustained rise in gas prices and challenges to building gas inventory ahead of winter. Other important risks to the euro are failure by the ECB to deliver on a credible 'anti-fragmentation' tool and persistent US inflation, which means the Fed continues to focus primarily on its price-stability mandate.

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