

## CURRENCIES: EUR/USD

## GROWING DOWNSIDE RISKS

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## SUMMARY

- › The euro has been hurt by a string of negative developments, from concerns about the credibility of the 'anti-fragmentation' tool being developed by the European Central Bank to increasing risks the euro area faces a profound energy crisis.
- › If those developments materialise, the euro may decline further against the dollar.
- › Given the current high uncertainties, we have decided to revise lower our three-month projections for the EUR/USD rate to USD1.00. This means our six-month and 12-month projections are mechanically adjusted to USD1.05 and USD1.09.

**A perfect storm in the making for the euro**

Since our last [note](#) on the EUR/USD exchange rate on 17 June, global developments have taken a turn for the worse for the single currency. Fears of a recession in the US have risen further (supporting the safe-haven US dollar), market scepticism has grown about the credibility of the European Central Bank's (ECB) upcoming 'anti-fragmentation' tool and, crucially, the market has been further discounting a deep energy crisis in the euro area as supplies grow scarce. As a consequence, the euro has declined sharply, recently posting 20-year lows against the US dollar.

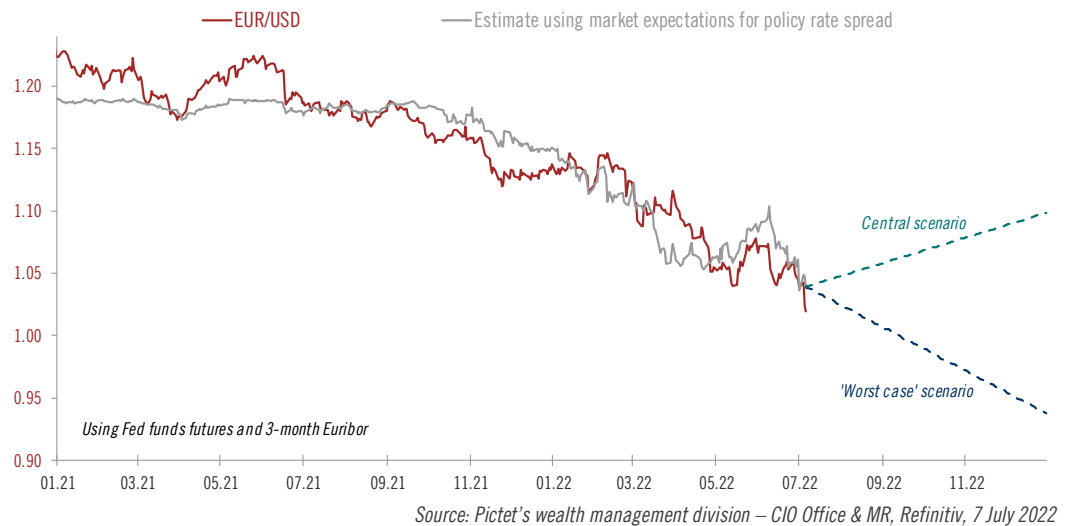
While the outlook for Russian gas supplies looks highly uncertain, it is impossible to ignore the growing risk that euro area countries will have to ration energy. This would have a significant impact on economic activity and have a knock-on effect on the euro. The main specific threat currently is that Russian gas flows through Nord Stream 1 pipeline will not resume after the scheduled end of seasonal maintenance on 21 July. (Nord Stream flows to Germany 60% below their normal levels since mid-June already). This has led to a further spike in natural gas prices, even though the price of many other commodities has started to decline. Adding to the energy concerns is the inability of alternative sources of electricity to fill the gap because of maintenance issues (notably at French nuclear plants) or because of drought (especially threatening hydro-electric generators). While our [central macro scenario](#) remains that the euro area will experience a 'mild' recession by the turn of the year, these recent developments increase the probability of a more severe one because of the risk of energy rationing and because elevated inflationary pressure continues to squeeze real incomes.

**Estimating downside risks for the euro**

There are several ways to approach the downside risk facing the euro versus the USD.

One is to use the rate differential. In a worst-case scenario, if we assume that fears of an imminent recession prevents the ECB from raising its deposit rate beyond the 25bp it has signalled for July and that the Fed follows through on its 'dot-plot' guidance (which points to a Fed funds rate of 3.5% by year's end), then the euro could fall as low as USD0.94. However, both the market and our own analysis point to a less severe outcome for the euro.

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**CURRENCIES: EUR/USD****GROWING DOWNSIDE RISKS****EUR/USD VERSUS ESTIMATE BASED ON MARKET EXPECTATIONS FOR ECB-FED POLICY RATES**

Alternatively, one could devise a forecast based on previous overshoots of long-term valuation metrics. The most extreme overshoot was in June 2001, when the euro fell to 27% below estimates of its long-term fair value against the dollar. A repetition of this episode implies a EUR/USD exchange rate at USD0.93—and even lower if we use a theoretical EUR/USD rate that pre-dates the creation of the single currency for our modelling.

A third possibility is simply to look at the period in the past when euro declined fastest against the US dollar since its creation in 1999. Using such methodology, EUR/USD could go as far as USD0.92.

All in all, modelling and history can provide rough estimates of where the EUR/USD exchange rate could go by end of 2022 if our current central scenario of successive ECB rate hikes and a mild recession does not hold true.

**Lowering our forecast for the EUR/USD rate**

While we believe current market fears may not fully materialise and while a number of factors supporting the euro are being overlooked (such as sharp improvements in net capital flows into euro area securities), we are also wary of sending too optimistic a message in the short term on the euro given the significant downside risks it faces. As a result, we have decided to lower our three-month projection for the EUR/USD rate to USD1.00 (from a previous USD1.06). This mechanically lowers our six and 12-month projections to USD1.05 and USD1.09, respectively (from USD1.11 and USD1.15). While we acknowledge that the fallout from the war in Ukraine could have a prolonged effect on the euro, we will reassess our latest projections after the ECB's next scheduled policy meeting on 21 July.

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