PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
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CURRENCIES: EUR/USD

PROJECTIONS REVISED LOWER

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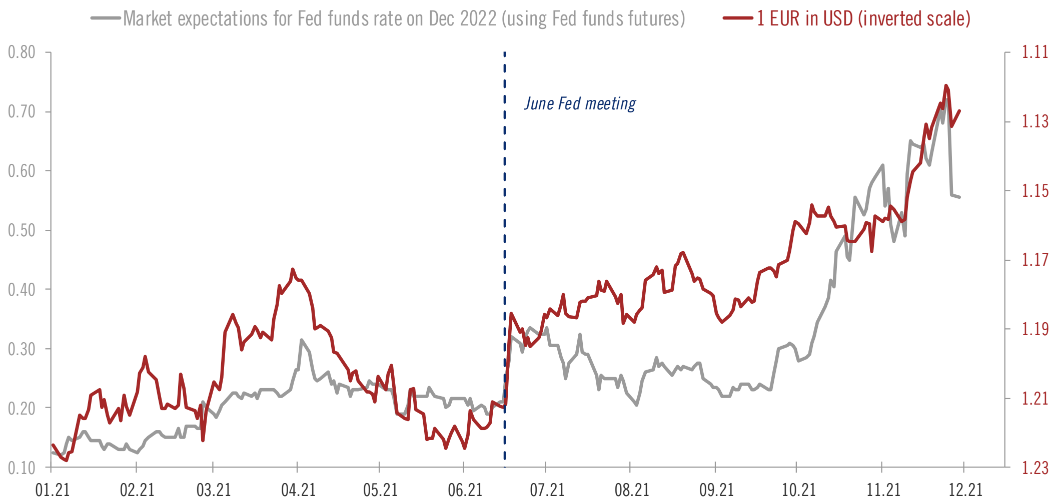
SUMMARY

- The euro has lost quite a lot of ground against the US dollar since the 16 June Fed meeting.
- Our new central scenario for Fed tightening favours three rate hikes in 2022 because of broadening inflationary pressure.
- Along with the fact that quite a hawkish Fed is already being discounted by the market, other factors such as growth differentials between the US and Europe are not favourable to the dollar.
- The US dollar's upside potential from its current USD 1.1250 per euro rate could prove limited. Our new projections stand at USD1.11 in three months, USD1.10 in six months and USD1.16 in 12 months.

CHART 1: MARKET EXPECTATIONS FOR FED FUNDS RATE VS. EUR/USD



Source: PWM - AA&MR, Refinitiv, 30 November 2021

The euro has fallen sharply since the middle of June

The euro has plunged in value against the US dollar since the Fed's meeting on 16 June, when its monetary stance turned less accommodative. The euro lost almost 8% from then until 24 November thanks to a sharp repricing of the Fed's plans for rates – the market has started pricing more than two hikes by the end of next year.

While we initially thought that the Fed would wait until 2023 before hiking rates, the recent broadening of inflationary pressure and the tightness of the US labour market have led us to adapt our central scenario, such that we now expect the Fed to hike rates three times next year. However, the European Central Bank (ECB) is nowhere near as close to hiking rates because of its strict forward guidance on rates and because inflationary pressure in the euro area looks less acute than in the US. As a result, monetary policy has turned significantly in favour of the US dollar relative to the euro.

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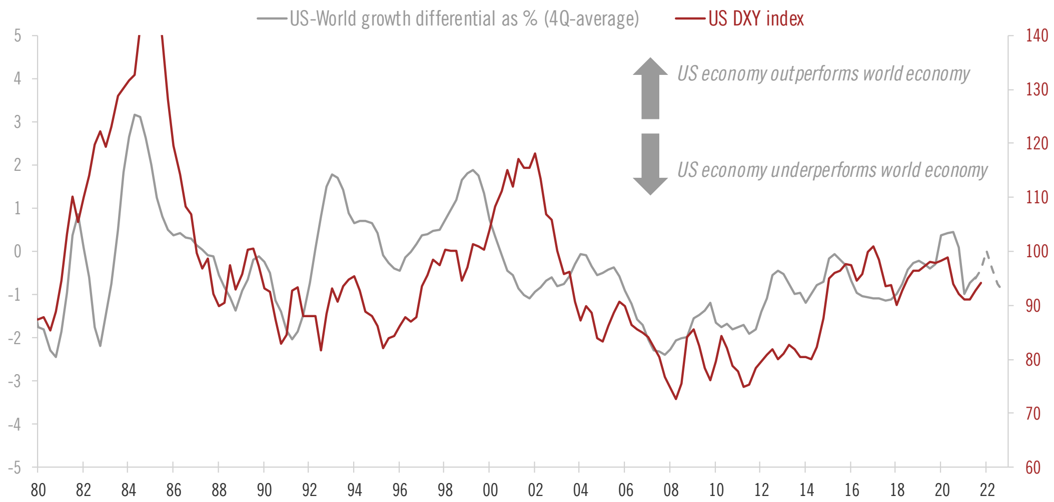
That said, we continue to think that the other key driver of the EUR/USD rate over the medium term – the difference in economic growth between the two regions – should move in favour of the single currency in 2022. What's more, since the market is already discounting a relatively hawkish Fed, the US dollar's upside potential could be limited from here based on those two medium-term factors.

CHART 2: US-WORLD GDP GROWTH DIFFERENTIAL (WITH PROJECTIONS) VS. US DOLLAR INDEX



Source: PWM - AA&MR, Refinitiv, 30 November 2021

Some factors that have been weighing on the euro should abate soon

The ECB's accommodative stance relative to other major central banks has been weighing on the euro, but this is not the only factor to have done so. In particular, the rising costs of energy imports have hit the euro area's trade balance, while the slowdown in China and the resurgence of covid cases in the euro area are casting doubts about the strength of the ongoing economic recovery.

Although we acknowledge that these issues could continue to weigh on the euro over the next few months, we see them as temporary in nature. Once winter has passed, energy costs and covid could become less of a concern. And our central scenario for Chinese growth is one of sequential quarterly improvements in 2022. Overall, negative factors weighing on the value of the euro should fade by the end of the first quarter next year.

Rising FX hedging costs to monitor

One factor that may be less transient in nature, however, is the potential scarcity of US dollar funding. This is reflected in increasingly negative EUR/USD basis swap (the premium demanded by counterparties to lend the US dollar on the FX swap market) that we have seen since the end of September. This development may be a consequence of the shortage of European collateral (German and French government debt) caused by the ECB's bond-buying programmes. ECB buying has led to an increase in demand for currency-hedged US Treasuries, pushing the EUR/USD swap basis deeper into negative territory.

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The ECB provided some relief on 16 November by easing its collateral rules, but the basis remains wide. As currency traders tidy up their books for the end of the year, we could see further tensions in the EUR/USD swap market. Overall, the high cost of hedging the US dollar against the euro may support the greenback.

The dollar could be vulnerable to external events

The biggest factor behind the strengthening of the US dollar in the second half of 2021 has probably been the market's expectations of a more hawkish Fed. While we realise that statements by Fed members have vindicated the market's expectations of a more rapid normalisation of monetary policy than had previously been anticipated, the dollar is vulnerable to any event that could result in the Fed becoming less aggressive than market prices are now discounting.

For example, the Fed delayed its tightening cycle in 2015 because of the Chinese economic slowdown. So, any worsening of the Chinese economic outlook – not our central scenario – could also have a negative impact on the US dollar as well.

What's more, the growing concerns about the new Omicron covid variant saw the US dollar fall against the major low-yielding currencies on Friday 26 November, suggesting that heightened worries about covid may not be fully supportive of the safe-haven US dollar because they could affect the timing of the Fed's first rate hike.

Limited scope for long-term dollar gains

On that note, we still expect the Fed's monetary normalisation to be constrained by the volume of debt in the financial system. Beyond 2022, the Fed may find it difficult to maintain its restrictive stance, which could ultimately hurt the US dollar.

With a longer-term horizon in mind, the US dollar appears expensive based on classic valuation metrics. US's twin deficits (current account and federal budget) also point to a weaker US dollar. Overall, while we acknowledge that the US dollar could continue to perform strongly in the coming months because of supportive monetary policy, we do not see any medium- or long-term factors in our central scenario that should result in the currency continuing to appreciate on a sustained basis.

New projections for the EUR/USD rate

Based on the factors we discuss above, we have modified our projections for the EUR/USD rate. Our three-month projection for the euro now stands at USD1.11, our six-month projection at USD1.10 and our 12-month projection at USD1.16.

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