

FX Strategy

EUR/USD lower for longer - but not forever

- We revise lower our EUR/USD forecast profile as a hesitant ECB and USD carry will keep the cross lower for longer. The next big move remains higher though.
- We now see limited upside potential on a 6M horizon, which makes risk reversals attractive relative to forwards for hedging USD income/assets at this horizon.

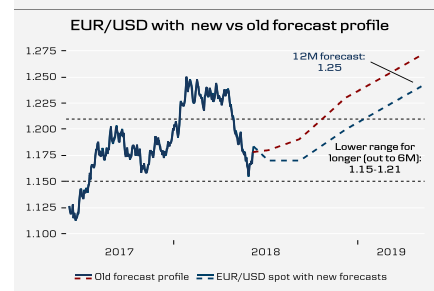
EUR/USD has been a rollercoaster recently and in last week's *FX Strategy: EUR/USD stuck in the mud (below 1.20) for longer*, we emphasised the case for EUR/USD to be lower for longer. We now opt to revise down our forecast profile for the cross, but we maintain that the next big move in the cross will still be higher, see Chart 1.

What has changed?

ECB. While the ECB remains in a process of policy 'normalisation', we stress that Mario Draghi and co are set to stay reactive rather than proactive when it comes to taking the next steps. Amid recent weakness both economically (activity data) and politically (Italy and trade), we doubt the ECB will want to rush to announce an end to QE next week; this should serve to halt the recent rally in EUR/USD (see *ECB Preview - End of QE approaching but no formal announcement just yet*, 8 June). Indeed, market pricing of the ECB has, in our view, become too hawkish, with a first 10bp set for July 2019 (we look for December) (see Chart 3). This said, hawkish hints at the press conference should retain market faith that the ECB is slowly but surely heading to the 'exit'; in our view, this will serve to keep the euro afloat.

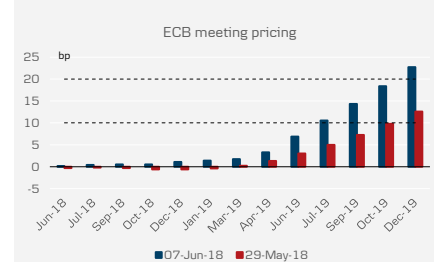
Carry. A recoupling between EUR/USD and relative rates has clearly been seen periodically of late. Indeed, the carry on long USD positions (notably vs EUR) appears to have reached a threshold where this is in itself a reason to buy the dollar. Further, our rate strategists have revised lower their forecasts for euro area vs US rates relative to market expectations especially for the near term, see *Yield Outlook*, 30 May. As we deem the rates recoupling is more permanent due to the rise of the USD as a 'carry' currency, this in combination points to USD support for longer, everything else equal (see Chart 4).

Chart 2: EUR/USD forecast profile taken down - but next big move is up



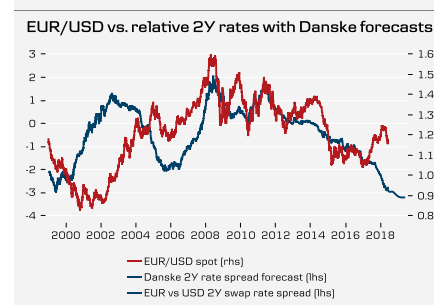
Source: Macrobond Financial, Danske Bank

Chart 3: ECB pricing has become more - and in our view too - hawkish



Source: Danske Bank

Chart 4: Recoupling with relative rates due to carry appeal of USD

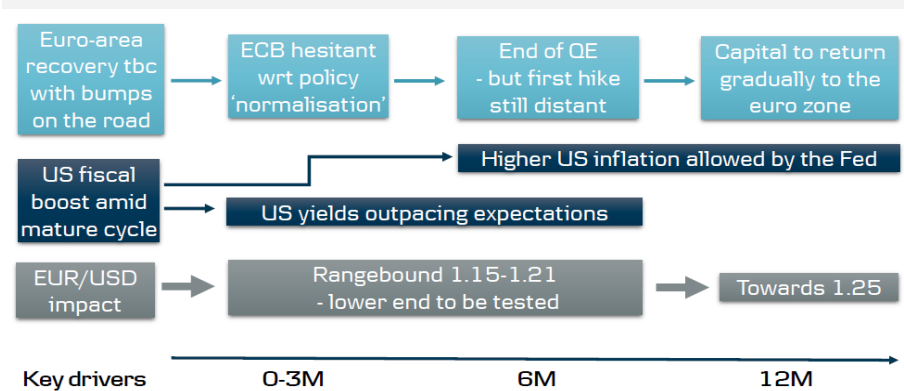


Source: Macrobond Financial, Danske Bank

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Chart 1: Key EUR/USD drivers at different horizons: lower range for longer - but heading towards 1.25 in 12M



Source: Danske Bank

Urgency of Italian debt sustainability. The new Italian government has put Italian fiscal sustainability back on the market agenda. Even if a euro exit is off the table, an Italy risk premium of a few big figures is set to stick to EUR crosses until a clearer verdict on sustainability can be made. Our Short-Term Financial Models indeed hint that the Italy-driven drop in EUR crosses was justified from a risk-premium point of view, see Chart 5.

Nature of trade war. As the US-initiated trade dispute is now set to take a more multilateral form, it is no longer obvious that it will just be associated with the Trump administration pushing for a weaker dollar. Indeed, the relatively open euro-zone economy stands to lose more from an all-encompassing standoff compared with the more closed US.

Outlook: stuck in 1.15-1.21 range for longer

We have long held the view that ECB policy ‘normalisation’ should continue to support EUR via the potential for this to lure capital flows back to the eurozone as more securities are lifted back into positive-yielding territory. **While the flow case remains intact and may in fact gradually have started to play out, see Chart 6, it looks set to take longer to materialise on a wider scale due to a foot-dragging ECB.** Meanwhile, a sustained upward pressure on US rates means USD will stay backed for ‘carry’ reasons - and Trump’s ‘America first’ rhetoric is further adding to the sense of USD assuming a new role. **In combination with a sticky Italy discount and the changing nature of the trade war, we do not see EUR/USD heading back to the mid 1.20s near term.**

Valuation still points to a higher EUR/USD further out though with our Medium-term Valuation (MEVA) measure for EUR/USD standing at 1.28, see Chart 7 – and our economists’ projections of continued inflation divergence in favour of the US, see *The Big Picture*, in fact suggest upside risks to this estimate. **Thus, the ‘direction of gravity’ hinted at by valuation remains upwards in the cross, and while not an outright cause for upside near term, it still serves to limit downside in the cross.**

Based on this, we opt to revise down our forecast profile for EUR/USD somewhat, and now see the cross at 1.17 in 1M, 1.17 in 3M (previously 1.19), 1.20 in 6M (1.23), and 1.25 in 12M (1.28). On a 0-6M horizon, we think the cross will broadly stay in the 1.15-1.21 range as counteracting forces are at play as discussed above. On a 6-12M horizon, the ECB is set to end QE and forward guidance on rates will take centre stage; even if hikes will remain distant by then, this should allow gravity to kick in as capital returns to the euro zone.

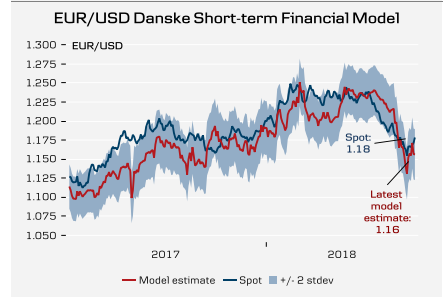
Strategy: risk reversals attractive for hedging out to 6M

We now see limited upside in EUR/USD on a 6M horizon, which makes risk reversals attractive relative to FX forwards for hedging USD income/assets at this horizon. We note 25 delta EUR/USD risk reversals have corrected higher across tenors following the big plunges seen in late May but risk reversals still trade in negative territory beyond the 1M tenor.

The 1Y risk reversal is currently the most negative point on the curve trading at -0.425 but when adjusting for implied volatility, we see most value in the 6M EUR/USD risk reversal when hedging USD income/assets.

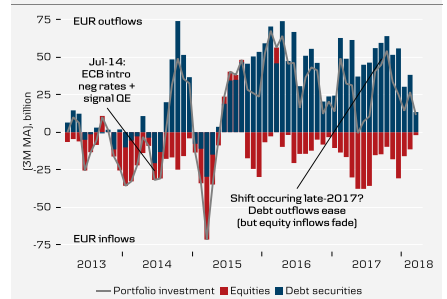
We are still long EUR/USD through a **bullish EUR/USD seagull** as one of our *FX Top Trades 2018 - How to position for the year ahead*, 6 December 2017. However, given the limited scope for a strong rally in EUR/USD within the 6M maturity remaining of this strategy, we will look for opportunities to close the trade on spikes in the spot.

Chart 5: An Italian debt risk premium is warranted in EUR/USD



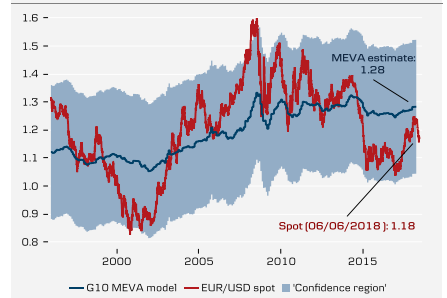
Source: Macrobond Financial, Danske Bank

Chart 6: Eurozone capital outflow may be starting to fade



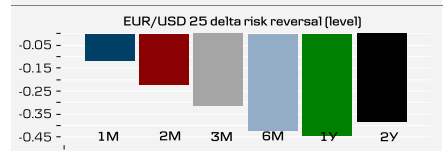
Source: Bloomberg, Macrobond Financial, Danske Bank

Chart 7: Valuation still suggests gravity is for a higher EUR/USD



Source: Eviews, Macrobond Financial, Danske Bank

Chart 8: 6M risk reversal most attractive when hedging USD assets



25D Risk reversals Vol Adjust. Z-Score					
2W	1M	3M	6M	1Y	2Y
-0,4	-0,8	-1,6	-1,7	-1,3	

Source: Bloomberg, Macrobond Financial, Danske Bank

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None.

Date of first publication

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