06 November 2018

FX Strategy

EUR/USD break of 1.13? Yes – and here's why

- **Real interest rates to pave the way for downside pressure in EUR/USD in 0-3M.**
- **We look for a break of 1.13 as US cyclical and carry outperformance rule.**
- **Cross still set to gravitate back to 1.15 and dips towards 1.1220 should be bought.**

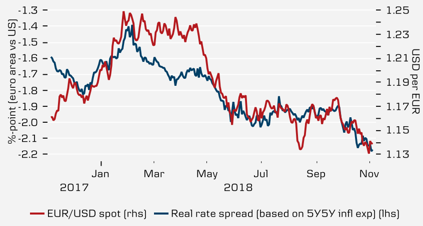
In yesterday's *FX Essentials* (5 November 2018) we stated that EUR/USD should be set for a break of the 2018 low (1.1301) before year-end. **Indeed, we see a range of factors making the cross now ripe for entering new lows.**

Looking back, whereas relative short-end rates have failed to capture movements in the cross in recent years, **a recoupling of EUR/USD with real longer-term yield spreads has been seen lately** (Chart 1). As US 10Y Treasury yields firmly broke the 3% level after the summer, the pricing of higher neutral rates and a wider term premium in Treasuries caused relative rates to make a comeback for and support USD crosses. At the same time, US inflation expectations have dropped amid US cyclical outperformance (both USD positives) as the Fed has made clear it is adamant to bring the rate to 'neutral'.

Looking ahead, we think the following three factors will determine the fate of EUR/USD heading into 2019. First, our quantitative business cycle models suggest **the US economy should fare better on growth for some time still than the euro area.** Indeed, the US fiscal boost is set to continue to add to US growth momentum well into 2019, and any fears of a US recession down the road are still too far away to be a USD theme. In the interim, the eurozone suffers from protectionism – not least via a struggling China – as well as from omnipresent political risks. Second, the Fed is entering a phase where it is more worried of falling behind the curve than the opposite. Meanwhile, despite eagerness to exit QE and eradicate negative rates, the ECB will be keen to underline its gradual and dovish approach as it has yet to see true signs of a pickup in core inflation. **This should continue to keep US yields supported and keep the carry lure of USD intact for some time still.** Third, a fragile environment for risk assets towards year-end, as global growth momentum is wearing off at a time where central banks are eager to tightening and political risks remain, should help sustain demand for safe-haven currencies. While the properties of USD are 'under review' in this context – due to e.g. USD carry and an 'America first effect' – **the most recent equity sell-offs have tended to be associated with USD support** (Chart 3). The risk of more of such risk bumps remain near term. **This week's midterm elections are unlikely to be a game changer:** in case of the widely expected outcome of a divided Congress, fiscal initiatives should be restricted to infrastructure (i.e. no new tax reform) and the trade dispute confined to China (i.e. not spreading). We expect a US-China trade deal further out (EUR/USD positive as the war on tariffs fade) but not imminently.

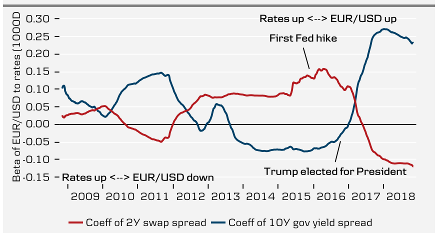
As a result, while a break failed to materialise last week, we think EUR/USD will move below 1.13 before year-end as real interest rates are paving the way. Even if a break of the 2018 lows takes us to new technical territory, we think the cross will tend to gravitate back towards 1.15 as we are in markedly undervalued territory fundamentally. **Thus, dips towards the 1.1220 level (26-Jul-17 high) should be bought into**.

Chart 1. EUR/USD and real long yields are recoupling



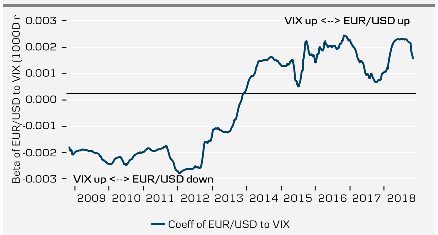
Source: Bloomberg, Macrobond, Danske Bank.

Chart 2. Long rates taking over from short rates as EUR/USD driver beyond first Fed hike



Source: Bloomberg, Macrobond, Danske Bank.
Note: Beta est on a 1000D rolling basis in the Danske Short-Term Financial Model framework.

Chart 3. Safe-haven properties of EUR/USD shifting



Source: Bloomberg, Macrobond, Danske Bank.
Note: same as Chart 2.

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