

FX Strategy

EUR/USD trap - escape routes blocked

- Cyclical pressure on ECB leaves scope for EUR easing risk premium near term
- EUR/USD in range around 1.13 on a 3M horizon - notably upside risks capped
- Hedge USD income/assets with risk reversals and stay long USD/SEK

With one exception (Norges Bank), central banks have in recent weeks given in on 'normalisation' efforts (Table 1) by either going on hold (Fed, BoC), postponing a first hike (RBA, ECB, BoE) or disclosing their locked positions (BoJ, SNB). We now see no more Fed hikes in this cycle (*FOMC review*), and for USD this means that carry momentum is ebbing out amid stretched long positioning and overvaluation. A USD downtrend? It is too early as talk of rate cuts is premature with the US economy to stay in decent shape this year. For EUR, a key question is if ECB will shift its rhetoric to whether - rather than when - a first hike is warranted. The bar for ECB to 'do more' is clearly lower after the March meeting, but it remains high due to a constrained toolbox and a new president in the autumn.

What then about EUR/USD? The cross has decoupled from relative rates lately: rate spreads have moved in favour of a higher EUR/USD - both in nominal and real terms (Chart 1) and across tenors. Our Short-Term Financial Model estimate currently stands at 1.15 (Chart 2). Together with a smaller risk of a no-deal Brexit, this helps to explain why the cross has failed to move lower despite Eurozone weakness lately. Will this support last? We think not. Global nominal yields have grinded lower since early autumn, but so have inflation expectations, suggesting market confidence in central banks has been in decline. In the US, break-even inflation rates started to recover around New Year when Fed shifted its stance, but Eurozone ones still look fragile. Thus, euro real rates remain on the rise (Chart 3) and elevated spreads to the US do not seem warranted by relative cycles. We expect global growth concerns continue to linger near term - indeed our quantitative business-cycle model *Macroscope* increasingly calls for stamina in this respect - which suggests ECB will have to put its money where its mouth is and bring lower real yields. Will it deliver? History says not (enough): that said, we do see potential for a wider 'ECB easing risk premium' to weigh on EUR/USD (*FX Strategy*), but to send EUR/USD below 1.10 will require a fundamental shift in ECB's stance on rates (e.g. more negative) and we doubt *that* will be delivered. However, we are not in for a firm EUR uptrend either just yet: for this, we need much firmer signs of a self-sustainable Eurozone recovery.

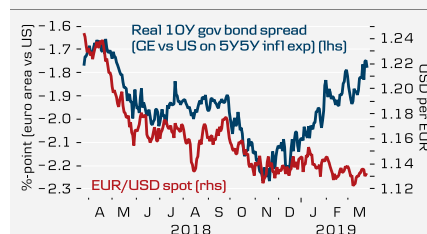
On a 3M horizon, we see EUR/USD trapped in a range around 1.13 but with risks tilted to the downside as ECB will be forced to keep a soft stance at a time where Fed looks more side-lined. Relative cyclical hints will be key near term - but a trade deal could be a knee-jerk USD positive. Beyond the 6M horizon, a drift higher will materialise as the skies clear a bit for the Eurozone, but we still merely target 1.17 in 12M. For now, ECB has effectively put a lid on the cross and with still heavy carry, we continue to advocate risk reversals when hedging USD income/assets. From *FX Top Trades 2019* we are long USD (versus SEK, JPY, CHF) for the carry, but due to the outlook for a fragile risk environment for some time still we close the JPY and CHF legs (Table 2), effectively leaving us long USD/SEK spot.

Table 1. Pricing Fed cuts is premature – but what's the scope on ECB?

As of 26/03/2019	2019	2020	2021
Last date	27/12/2019	29/12/2020	29/12/2021
ECB	1.5	8.8	15.0
FED	-27.3	-30.2	-1.7
BoE	-3.8	5.8	9.0
BoJ	-1.9	-6.1	0.2
SNB	-1.6	6.3	18.2
Riksbank	8.4	19.0	19.7
Norges Bank	25.4	8.8	5.5

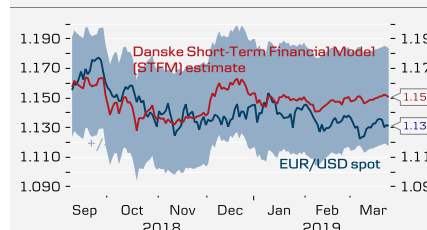
Source: Danske Bank (DB)

Chart 1. Real rates spreads have held a hand under EUR/USD



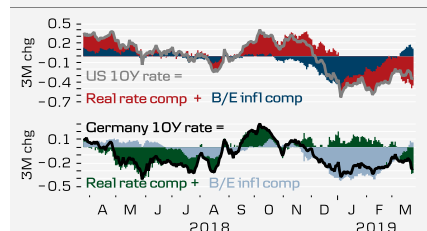
Source: Bloomberg, Macrobond Financial, DB

Chart 2. Short-term factors say EUR/USD 'fair' at 1.15



Source: Bloomberg, Macrobond Financial, DB

Chart 3. Fed has guided real rates down – ECB much slower to react



Source: Bloomberg, Macrobond Financial, DB

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Open FX Top Trades 2019

#	Trade	Opened	Entry	Closed	Current	PnL
2	Long NOK/SEK spot outright	03/12/18	1.0569		1.0832	2.92%
3	Long EUR/USD via 9M 1.1475 call financed by sold 3M 1.1200 straddle	03/12/18	1.1334		1.1309	-0.25%
4	Long USD carry basket vs JPY, SEK, CHF*	03/12/18	100.00		100.62	0.62%

* CHF and JPY legs closed on 26 March 2019

Source: Bloomberg, Danske Bank

Closed FX Top Trades 2019

#	Trade	Opened	Entry	Closed	Close level	PnL
6	Short NZD/CAD spot outright	03/12/18	0.9125	17/01/19	0.8958	1.78%
7	Short EUR/HUF spot outright	03/12/18	322.84	21/01/19	317.58	1.63%
5	Sell 1MEUR/GBP 0.8700 put to finance 4M 0.8700 put	03/12/18	0.8555	27/02/19	0.8576	1.03%
1	Short EUR/NOK via 3M 9.3500-9.6918-9.9500 1:1:2 bearish seagull	03/12/18	9.6918	01/03/19	9.7434	0.00%

Source: Bloomberg, Danske Bank

Overview of FX Top Trades 2019

	#	Cumulative Return	Average Return
Profitable	5	8.0%	1.6%
Neutral	1	N/A	N/A
Loss-Making	1	-0.2%	-0.2%
All Trades	7	7.7%	1.1%

Source: Bloomberg, Danske Bank

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