PICTET 1805

Flash Note

Currencies: EUR/USD

Adopting a more neutral tactical stance

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Following the recent ECB and Fed monetary policy meetings, real interest rates differentials have been supportive of a stronger euro against the US dollar.

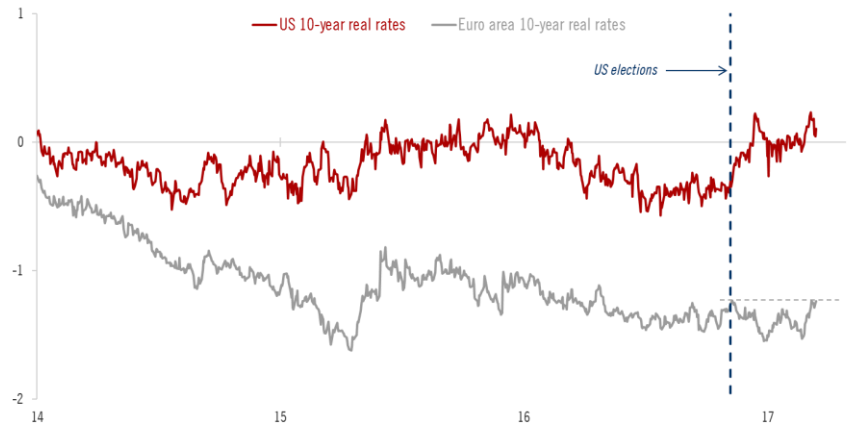
Our scenario of no political accident in the French election and a more hawkish ECB at its June monetary policy meeting suggest limited downside potential for the euro in the short term.

Consequently, the EUR/USD rate is likely to move in a relatively broad range between 1.05 and 1.10 in the next few months and not towards parity as previously expected.

The prospect of looser fiscal policy in the US and subdued inflationary pressure in the euro area still point to a somewhat lower euro against the USD.

The monetary policy meetings of the European Central Bank (ECB) on 9 March and of the Federal Reserve on 15 March have put upward pressure on the euro versus the US dollar. Euro area real rates have risen on prospects for an early rate hike whereas US real rates have declined on the perceived dovishness of the Fed (*see chart 1*). Consequently, the real rate differential, a key driver for currencies, has been favouring the euro against the US dollar in recent days. Coupled with broad positive macro data in the euro area and increasing signs that US fiscal stimulus might be delayed, the EUR/USD rate moved from about 1.05 on 9 March to around 1.08 eight days later.

Chart 1: 10-year real rate



Source: Pictet WM – AA&MR, Bloomberg

Limited short-term downside potential for the EUR/USD

Looking ahead over the next few months, we do not expect any political accident during the French presidential election and it is very likely that the ECB will adopt a more hawkish stance at its monetary policy meeting on 8 June. These two events are expected to be supportive of the euro. Consequently, a decline below EUR1.05 per USD in the next few months seems quite unlikely.

That being said, we now expect the Fed to raise rates again in June and September, which should be supportive of the greenback and abate some concerns that the Fed is willing to let the US economy overheat. Furthermore, inflation in the euro area is unlikely to improve significantly in the near future, and the recent rise in the euro area real rate is unlikely to help either.

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Overall, the EUR/USD rate is likely to move in a relatively broad range between 1.05 and 1.10 in the next few months. From a tactical point of view, we believe downward pressure on the EUR/USD rate is likely before May as inflation in the euro area disappoints again and uncertainties about the French election linger. Upward pressure on the euro is likely afterwards on the back of non-election of Marine Le Pen and the hawkish tilt we expect the ECB to adopt in June.

Medium-term USD strength still favoured

In the longer term, there is no denying that the USD's current long-term upward cycle is maturing. The two previous long-term USD appreciating trends have lasted between 77 and 80 months. The current one started in July 2011. Furthermore, in terms of valuation, the US dollar index is near extreme overvalued territory, as it stands at just below the 20% overvaluation mark (*see chart 2*).

Chart 2: USD index purchasing power parity

Source: Pictet WM – AA&MR, Thomson Reuters

We acknowledge that monetary policy divergence is unlikely to remain a strong positive factor for the greenback as the ECB shifts towards a more hawkish monetary stance. However, the expectation of looser fiscal policy in the US should lift the USD again, on the back of a higher growth outlook. Furthermore, given reduced slack in the economy, the US is prone to generate inflationary pressure at some stage down the road. In the euro area, notwithstanding the rebound in oil prices, inflationary pressure remains subdued. Consequently, any normalisation of the ECB's monetary policy is likely to be very gradual.

Therefore, in our opinion, it is too soon to call for the end of the depreciating trend in the EUR/USD. Furthermore, although European political uncertainties should abate after the French elections, the lack of deeper integration and a possible rise in non-German yields should weigh on the euro area's growth potential and on the structural issues facing weaker members such as Italy.