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CURRENCIES: EUR/USD

CAP MAINTAINED, SPEED REDUCED

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SUMMARY

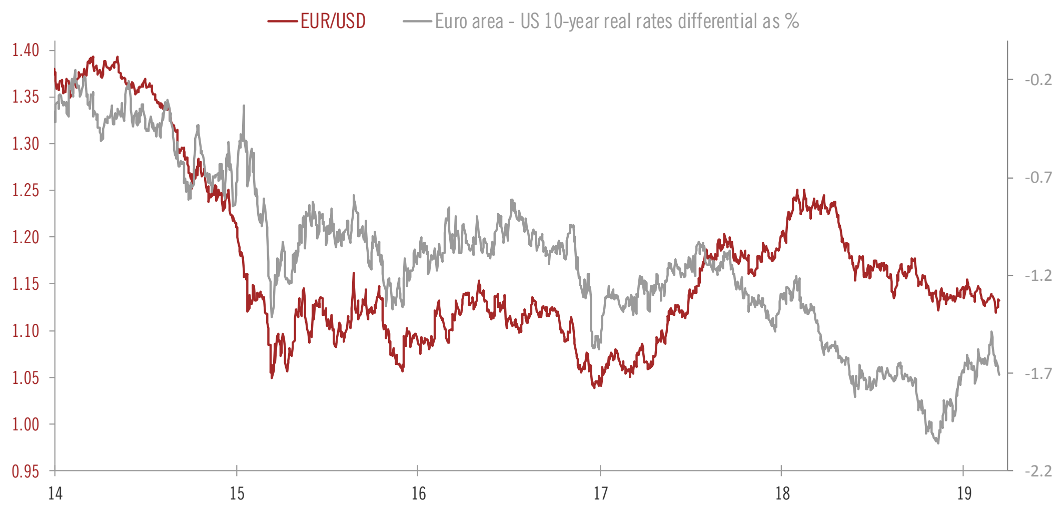
- The euro fell to a 20-month low against the US dollar following the March ECB policy meeting, given revised forward guidance that suggests that the interest rate differential is unlikely to provide much upside to the euro in the next few months.
- We see recent PMI surveys as early signs of a rebound in euro area economic activity. Coupled with our scenario of abating external threats, the growth differential should soon prove more supportive of the euro.
- Given a less supportive interest differential, we have decided to lower our projections for the EUR/USD rate. We now favour a move towards USD1.14 in three months, USD1.17 in six months and USD1.20 in 12 months.

Rate differential unlikely to boost euro in the next few months

We have long argued that the US dollar should weaken as two key drivers (growth and interest rate differentials) are likely to prove less supportive in 2019. Indeed, the Federal Reserve (Fed) is less hawkish than in 2018 and US GDP growth is poised to moderate as the impact of President Trump's tax cuts fades.

However, when analysing the EUR/USD rate, the underlying assumption is that euro area growth will fare better than in the US and that the European Central Bank (ECB) will normalise monetary policy. The improvements in the rate differential between the euro area and the US since mid-November 2018 (*see chart 1*) has come from a decline in US rates, rather than a rise in euro area rates. At the same time, the growth differential has deteriorated as quarterly GDP and leading economic indicators have remained thus far in favour of the greenback over the single currency.

CHART 1: EUR/USD AND 10-YEAR REAL RATE DIFFERENTIAL



Source: PWM - AA&MR, Bloomberg, data as at 13.03.2019

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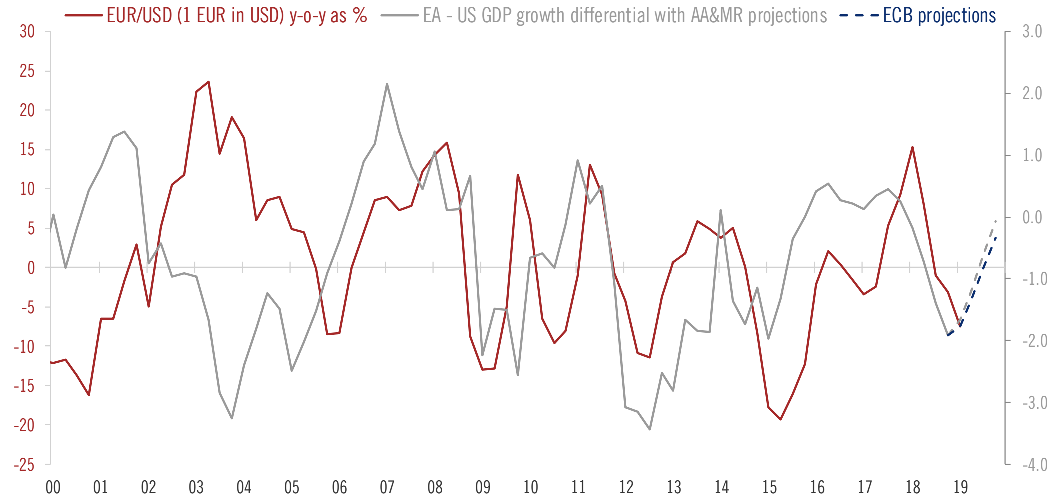
The very dovish stance espoused by the ECB on 7 March rules out any rate hikes this year, implying that the interest rate differential may not prove very supportive of the euro in the next few months (see ECB Rates And TLTRO-III: Devil In The Details). However, it should be pointed out that markets had already mostly priced out any rate hike this year, which may explain part of the relative resilience of the EUR/USD rate after 7 March.

Growth differential to the rescue of the euro

Another issue for the single currency related to the March ECB monetary policy meeting comes from the sharp reduction in the projections for key macro indicators, especially GDP growth (which was revised from 1.7% to 1.1% for 2019). However even with these projections, the growth differential between the euro are and the US should turn more supportive of the euro in 2019 (*see chart 2*). Furthermore, the ECB made only a moderate downgrade to its GDP growth forecast for 2020 (from 1.7% to 1.6%), which would make GDP growth particularly supportive of the euro in 2020.

That being said, recent PMI surveys in the euro area tend to favour the stabilisation of economic activity (after a relentless decline since December 2017), which supports our rather more constructive scenario on the euro area (GDP growth at 1.4% in 2019) based on resilient domestic demand and abating external threats (China, car tariffs and Brexit). This expected improvement could also lead to a less dovish ECB later this year, reigniting the rate differential driver in favour of the euro.

CHART 2: EUR/USD AND GDP GROWTH DIFFERENTIAL



Source: PWM - AA&MR, Thomson Reuters, ECB, data as at 13.03.2019

Euro still expected to gradually appreciate against the dollar

As previously mentioned, we fail to see drivers that may lead to a stronger US dollar: US GDP growth should moderate, the Fed is expected to end its tightening cycle this year, the current account and government budget are both in deficit and the currency looks significantly overvalued. However, for the dollar to depreciate, given the carry it provides, the macro data outside of the US must improve.

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In the months ahead, our scenario of abating external threats circling the euro area and a rebound in the economic activity, coupled with reduced scope for a more dovish ECB, still point towards a strengthening of the euro. However, as these developments may take time (if the US Commerce Department investigation has found that imported vehicles pose a national security threat, Trump has 90 days from 17 February to decide if he wants to impose car tariffs; a short-term extension to Brexit could last up to three months; euro area economic activity should rebound in the second half of the year), the short-term upside seems limited.

Consequently, we have revised our three-month forecast for the EUR/USD rate to USD1.14 (versus USD1.16 previously). This leads to a revised six-month forecast at USD1.17 (versus USD 1.18 previously) and a 12-month forecast at USD1.20 (versus 1.22 previously).

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