EUR/USD: Euro flexing its muscles

The euro has gained considerable ground in recent weeks. Waning political risks, coupled with nascent rate hike fantasies, have driven EUR to a two and half year high. Today, the European common currency can almost be considered a hot item: the breakout above key technical resistance barriers has resulted in a spate of follow-through buying. From a fundamental viewpoint, though, there are a number of factors that argue for a weaker euro, or, as it were, a stronger US dollar in the weeks ahead.

Euro the darling; USD the runt of the litter

The euro has become the darling child of the financial markets. Emmanuel Macron's victory in the French presidential elections as well as a better than generally expected eurozone economy sparked the upside move in EUR. And ECB head Mario Draghi added fuel to the fire: at last month's ECB Forum in Sintra (Portugal), the supreme guardian of Europe's currency offered an upbeat outlook for the economy, thereby giving rise to renewed rate-hike fantasies in the financial markets.

Meanwhile, the news from America was more sobering: key leading economic indicators retreated noticeably and were ultimately confirmed by weaker than anticipated growth in the first half of 2017. The White House also added a pinch to this already oversalted soup: Donald Trump's disclosure of top secret information to Russia aroused fears that impeachment proceedings could be initiated against him.

Eurozone: Buoyant economy, but no inflation

The receding political risks and better than expected leading indicators do in fact suggest that robust growth lies ahead for the eurozone in the coming quarters. Nonetheless, the pace of inflation should continue to fall short of the ECB's target range for quite some time. The rationale: unemployment still stands at a high 9.4%, which is why salaries in the eurozone as a whole will hardly budge. As a result, the core inflation rate (aggregate price growth excluding food and energy prices) will remain stuck in the vicinity of 1% far into 2018. Mario Draghi also touched on this point by noting that a phase-out of the central bank's ultra-expansive monetary policy can only be accomplished in very gradual steps. In this regard, the ECB intends to stick with its forward guidance, meaning a rate hike will only take place once the central bank has discontinued its monthly bond purchases. But the fact remains that the ECB is under pressure to taper those purchases during the course of 2018, as otherwise it would violate the limits that were established at the outset of the programme (i.e. no more than 33% of the bonds of any given issuer may be purchased). So, in a nutshell: Although the central bankers in Frankfurt's Eurotower will gingerly wind-down the bond purchases over the next twelve months, a rate increase prior to 2019 is hardly in store. Hence current market expectations are wide of the mark.

EUR/USD: The technical view

The recent upside move in EUR/USD has been all the more pronounced due to the technical resistance lines that were penetrated in the process, the most important of which were the breaks above 1.0850 and then 1.10. The recent leap over the 1.1550 mark finally put an end to the sideways trend that has been etched on the chart for more than two years. A takeout of resistance at 1.1680 would now lead to an immediate attack on 1.1880 and ultimately to the psychologically crucial 1.20 mark.

EUR/USD: Lower prices expected

Given the prevailing fundamentals, we stand by our prognosis and expect that the coming months will rather see weakness in EUR. A variety of indicators suggest this will be the case:

- All rate differentials we track (forward rates, nominal yields, inflation-adjusted yields) are pointing towards a decline in the EUR/USD currency pair.
- In response to the "europhoria", speculative traders have built up sizeable long positions in EUR – a caution sign due to the contraindicative nature of that skew.
- As to the USA: The significant decline in rate-hike expectations of late is unjustified in our opinion. The Fed will stick with its gradual rate increases, even as the FOMC weighs a downsizing of the Fed's balance sheet. Especially the latter move would be grounds for a significant recovery in USD.

Summary

Although from a short-term technical point of view it cannot be ruled out that EUR/USD at least attempts to keep up its assault on the 1.20 mark, a wide array of fundamental aspects argue for lower quotes in the months ahead. We therefore stand by our forecast and are reckoning with a renewed retreat towards 1.10 in EUR/USD.

Contact

VP Bank Ltd	Aeulestrasse 6 9490 Vaduz · Liechtenstein T +423 235 66 55 · F +423 235 65 00 · info@vpbank.com
VP Bank (Switzerland) Ltd	Bahnhofstrasse 3 8001 Zurich · Switzerland T +41 44 226 24 24 · F +41 44 226 25 24 · info.ch@vpbank.com
VP Bank (Luxembourg) SA	26, Avenue de la Liberté L-1930 Luxembourg · Luxembourg T +352 404 770-1 · F +352 481 117 · info.lu@vpbank.com
VP Bank (BVI) Ltd	VP Bank House · 156 Main Street · PO Box 2341 Road Town · Tortola VG1110 · British Virgin Islands T +1 284 494 11 00 · F +1 284 494 11 44 · info.bvi@vpbank.com
VP Bank (Singapore) Ltd	8 Marina View · #27-03 Asia Square Tower 1 Singapore 018960 · Singapore T +65 6305 0050 · F +65 6305 0051 · info.sg@vpbank.com

Content responsibility

Bernd Hartmann, Head Group Investment Research

Dr. Thomas Gitzel, Senior Economist

Important legal information