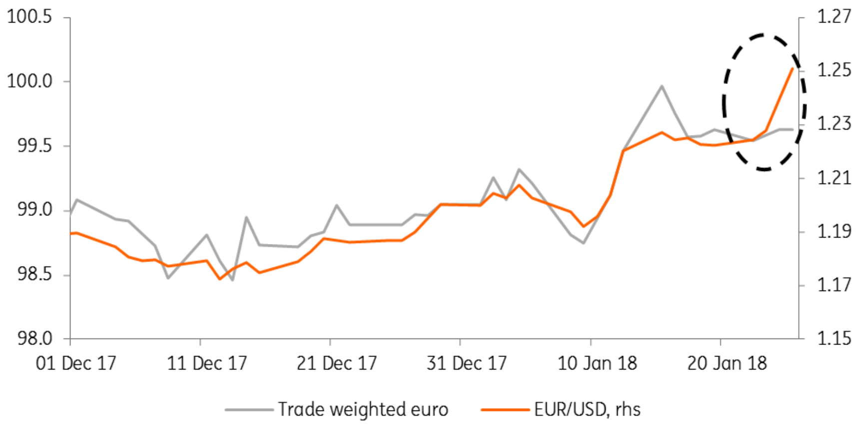
EUR: Not much the ECB can do

It has been hard for President Draghi to talk down the EUR when its strength is driven by a solid domestic economy and the soft USD. Even at 1.25, EUR/USD is not out of sync with the short-term fundamentals. We target EUR/USD 1.30 this year. CEE FX remains in the sweet-spot.

EUR/USD broke above the 1.2500 level for the first time since December 2014 as the market looked through ECB's President Drahgi's attempts to calm strong EUR expectations either via referring to the currency's "v*olatility creating uncertainty"* or seeing "*very few chances at all for a rate increase this year*." See also ECB Review.

Volatility is not strength

On the former, while clearly pointing at the recent EUR moves, we note that in terms of wording, referring to "volatility" is different and, in a sense, less interventionist than talking about euro "strength" or "abrupt" moves. While the headline news has recently been on the EUR/USD cross (and its appreciation) we note that the trade-weighted EUR materially lagged the EUR/USD strength (Fig 1) this year. This is because a non-negligible part of the EUR/USD upside was caused by the recent across-the-board USD weakness generated by the US administration comments (as is evident in Fig 1, the trade weighed EUR has actually been flat over the past days; or as per Fig 2 which shows EUR as an average G10 FX performer so far this year).



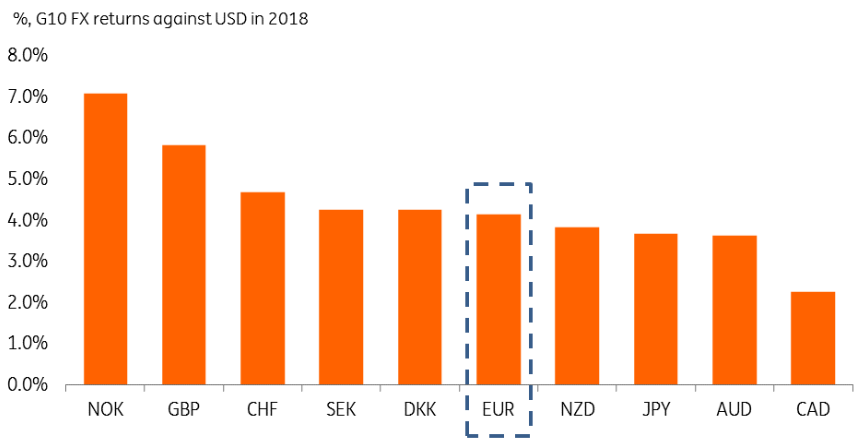
Source: ING, Bloomberg

It is not only about getting carried away by the ECB

Indeed, the above was (indirectly) cited by President Draghi as one of the three causes behind EUR strength:

1. Unquestionable improvement in the EZ economy
2. Heightened market sensitivity to perceived changes in the ECB communication
3. Dollar weakness (suggested implicitly, not explicitly) – as per above

However, so long as the ECB acknowledges that a non-negligible part of the EUR/USD strength is driven by weak USD as well as the very clear improvement in the Eurozone economy, the bar for the ECB to talk down the euro is high.



Source: ING, Bloomberg

EUR/USD still not overshooting

Note that based on our short-term financial fair value model, the EUR/USD is now fairly valued (on a short-term basis), even at around the 1.25 level. We thus don't see the current level as unsustainable or out of sync with short-term fundamentals. On a long-term basis, we reiterate OECD PPP EUR/USD fair value of 1.33.

No ECB rate hikes this year, but eventually helping the EUR in 2H18

We agree with Draghi's assessment on the deposit rate hikes. As per his comments, we don't look for the ECB to start normalising the deposit rates this year. However, we still continue to see expectations of the eventual deposit rate normalisation as an important driver for EUR/USD in the second half of this year once forward-looking market participants start to meaningfully price in deposit rate hikes for 2019.

We also note that the market is currently pricing around 5bp of ECB deposit rate hikes for this year. This is not aggressive and in turn reduces downside risks to the EUR from the eventual dovish re-pricing of the 2018 ECB deposit rate outlook (i.e. from 5bp to 0bp). We reiterate our long-held target of EUR/USD 1.30 by the year end (see EUR: Embrace the strong euro from the 2018 FX Outlook).

CEE FX: The EUR/USD on steroids

By extension, the CEE FX has been benefiting from the EUR/USD rally. All PLN, CZK and HUF have been up by around 5% against USD so far this year. All three currencies are among the top seven EM FX performers, only surpassed by the previously battered currencies (likes of ZAR and MXN) or the commodity currencies such as COP.

This is in line with our view that 2018 will remain the sweet-spot for the CEE FX (as was the case the last year) and this currency segment should do well this year, benefiting from our view of EUR/USD reaching 1.30, as well as their solid domestic fundamentals, thus transforming into the EUR/USD on steroids.