EUR: The funding currency

The euro is no longer cheap against the US dollar, growth remains sluggish and the prospects for ECB tightening are weak. In short, we're not excited about the euro

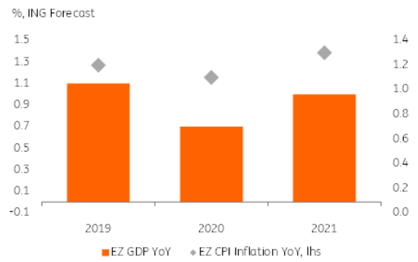
- **We remain unexcited about the euro. The currency is no longer meaningfully cheap vs. the US dollar, growth remains sluggish and the prospects for ECB tightening are weak.**
- **With EUR offering deeply negative implied yields, it should be used as the funding currency of choice for investors searching for yield in the undervalued emerging market FX world.**
- **A 2017-like EUR/USD rally is off the table as eurozone fundamentals are weak. We look for a range bound EUR/USD (1.10-1.15) next year, with clear downside risks.**

The ECB is presiding over a low growth, low yielding euro environment...

In a nutshell, the European Central Bank's policy stance and its implications should remain a drag on the euro. The September ECB easing package (10 basis point deposit rate cut and the restart of quantitative easing) was not strong enough to meaningfully improve the eurozone's growth and inflation prospects. As Figure 24 shows, economic growth will remain lacklustre (growth rate at / below 1.0% over the next two years) and inflation should remain persistently below the 2% target. On a comparative basis, EUR screens as one of the least appealing G10 currencies from an output gap and CPI targeting point of view (Figure 15 on page 12). Indeed, with the ECB's forward guidance conditional on CPI “robustly” converging to the target, this means one thing; any ECB policy normalisation remains off the table, with the policy rate staying negative and the ECB continuing to purchase eurozone bonds.

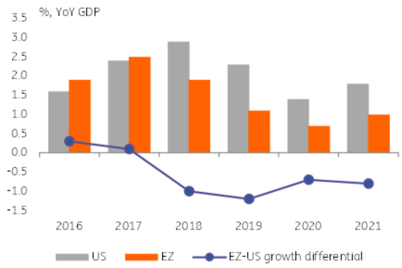
All this suggests that an idiosyncratic, domestically-driven EUR rally is unlikely. The September ECB easing package seems insufficient to change the outlook for eurozone growth and CPI but looks sufficient enough to keep the euro low – as EUR interest rates remain negative and growth is uninspiring (the latter confirms the need for the former).

Fig 24 **Uninspiring EZ growth and inflation prospects**



Source: ING

Fig 25 **EZ GDP growth still to lag the growth in the US**

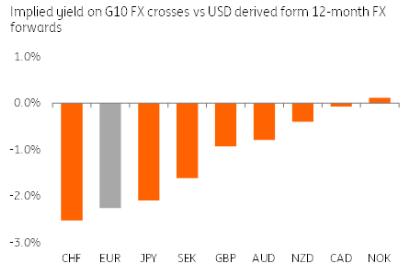


Source: ING

...making a 2017-like EUR/USD rally unlikely

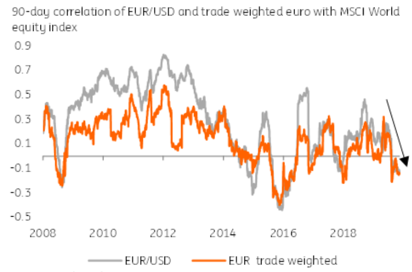
The absence of potential ECB policy normalisation makes us reluctant to call for a meaningful rise in EUR/USD. A repeat of the significant 2017-like EUR/USD rally is, in our view, off the table. Back in 2017 it was the market pre-positioning for the ECB QE tapering that was the key driver behind the EUR rally. As both eurozone growth and inflation outlooks are now meaningfully worse, any hint of ECB policy normalisation is unlikely. Not only is the ECB's stance and EUR valuation (see below) different now compared to 2017, but the eurozone GDP growth differential vs the US was also more appealing for EUR in 2017. As per Figure 25 , it was marginally positive in 2017 while in 2020 it should stay negative (albeit modestly less so than this year). This should also limit EUR/USD upside potential.

Fig 26 **EUR exerting attractive funding characteristics...**



Source: ING, Bloomberg

Fig 27 **...being no longer positively correlated with risk**

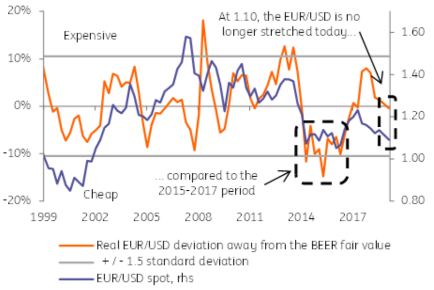


Source: ING, Bloomberg

Appealing characteristics of a funding currency

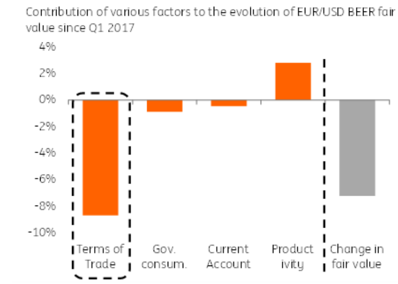
With EUR offering the second lowest/most negative implied yield in the G10 FX space (Figure 26) and little prospect for a credible turnaround, the euro should become a funding currency of choice. On a risk-adjusted basis, EUR funding characteristics look more appealing vs its peers as it does not exert the same safe-haven properties as the US dollar or Japanese yen. This means that during the period of risk-off moves, the euro is unlikely to appreciate as much as the dollar or the yen, in turn reducing the possible loss/probability of a stop loss being hit on long emerging market FX positions/high beta FX positions when funded in EUR. In fact, we have already seen the first signs of EUR attaining funding currency characteristics as EUR/USD and trade weighted euro correlations with risk turned negative in recent months (Figure 27). This means that EUR no longer benefits much during risk-on days.

Fig 28 EUR/USD is no longer cheap (compared to 2015-17)



Source: ING

Fig 29 EUR/USD fair value deteriorated



Source: ING

EUR is no longer cheap as its fair value has declined

Importantly, as Figure 28 shows, EUR/USD no longer screens as undervalued based on our medium-term BEER valuation framework. This is a meaningful change from the period of 2015-17 when at that time EUR/USD around 1.10 screened as heavily cheap. What has changed is the EUR/USD fair value, which has deteriorated by around 7% since 2017 largely due to the terms of trade dynamics (Figure 29). The lack of undervaluation also limits the scope for any meaningful EUR/USD upside (such as the one observed in 2017).

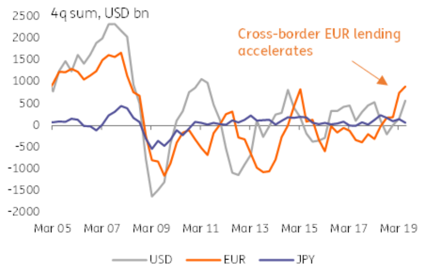
German stimulus the key hope for the euro – but unlikely

The greatest EUR hope lies with possible German fiscal stimulus. In an environment where the ECB's monetary policy stance is perceived as largely exhausted, large and credible fiscal stimulus which would improve eurozone growth and the inflation outlook would be a game changer for EUR as it would unleash the euro reflation trade and lead to higher EUR/USD (with the market upgrading the EZ growth outlook and expecting ECB policy normalisation). We see the odds of fiscal stimulus as rather low, meaning EUR should remain in the low growth, low yielding currency bucket.

Slowly creeping euro Japanization

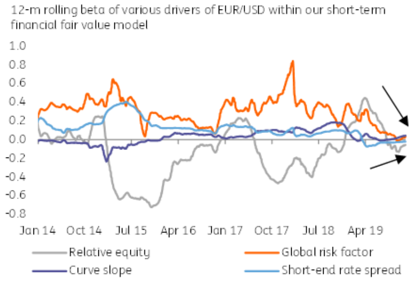
The EUR is increasingly resembling the characteristics of the Japanese yen. A low growth, low inflation, low yielding currency where the central bank delivers insufficient easing to boost the economy. While the eurozone current account is in surplus, it is offset by portfolio outflows. Depressed eurozone bond yields are starting to negatively affect the outlook for European pension fund returns, which has negative implications for pension distribution. The insufficient return potential from depressed eurozone bond yields may push some investors out of eurozone assets, searching for higher yield abroad. Additionally, cross-border lending in euro is accelerating, supporting the euro as a preferred funding currency. (Figure 30).

Fig 30 Cross-border lending in EUR takes off



Source: BIS, ING

Fig 31 EUR/$ Financial Fair Value: Rolling betas compres



Source: ING

Unexciting, uninspiring euro prospects with downside risks

We remain deeply unexcited about the euro's prospects and look for a range bound EUR/USD (1.10-1.15) next year, with risks skewed to the downside (ie, EUR/USD below 1.10).

These risks include another set of disappointing eurozone data, re-escalation of the US-China trade war (a clear negative for a large open economy such as the eurozone), possible auto tariffs, and the never-ending internal eurozone political risks. Moreover, with the USD-EUR interest rate differential unlikely to decline meaningfully from here (in turn cementing the dollar’s carry advantage), the EUR/USD may just slowly but surely creep lower in a very slow burning fashion – simply because there will be (yet again) nothing to see in the eurozone and the euro next year.

With EUR/USD losing its sensitivity to many of its usual short-term drivers (as Figure 31 shows, the betas of various EUR/USD driving factors have recently converged to zero within our short-term financial fair value model), range bound EUR/USD trading or a slow burning decline, looks like a real possibility. With the forward curve rather steep (12-month EUR/USD forwards at 1.1265 vs spot 1.1016), speculative long EUR/USD positions remain unattractive and offer limited return potential.

This article is part of our 2020 FX Outlook report.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/USD	1.11	1.10	1.10	1.11	1.12	1.13

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