EUR/USD: 1.20 is in sight – how do we get there?

The dollar's bearish march has continued after the Middle East crisis brought scattered, short-lived support. EUR/USD has broken 1.170 and is setting its sights on 1.20. The recent short-term rate swings have increased the upside risks, but something needs to happen on tariffs, Treasuries or the Fed for a run to 1.20

The Middle East crisis underscored the recent fragility of the dollar. A spike in geopolitical risk and oil prices should have sent an oversold and undervalued dollar soaring, but the support for the greenback was instead small in size and duration. It's true that the highly efficient forward-looking FX market never really traded the big risks of a prolonged conflict and sustainably higher energy prices. But that was at least partly due to widespread aversion to holding dollars due to medium-term considerations. The slow dollar reaction to canonically supportive news (like the oil spike) relative to the rapid return to the lows as soon as geopolitical tensions abated tells us that those considerations remain firmly relevant for short-term price action.

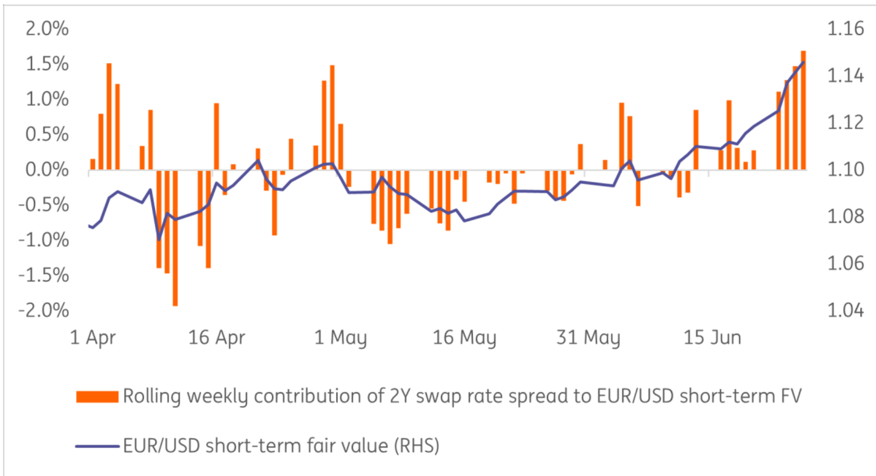
Short-term EUR/USD fair value has spiked

Short-term drivers of EUR/USD have also shifted. Our model shows that EUR/USD fair value has risen from just below 1.10 to 1.145 in the past 15 days, primarily driven by a 20bp+ tightening in the EUR:USD swap rate gap in favour of the euro. That is a consequence of markets embedding a more divided and dovish-leaning FOMC, while a hawkish ECB tilt has supported front-end EUR rates.

This means that at 1.170, the risk premium of EUR/USD is around 2.5%, roughly half compared to a couple of weeks ago when the pair was trading at 1.160. A misvaluation of 3% would normally be considered overstretched (over 1.5 standard deviation), but we have seen persistent overvaluation of 4-5% since 'Liberation Day'. In other words, if markets decide to price back the amount of USD risk premium that prevailed in the past two months, EUR/USD should trade very close to 1.20.

But what are the conditions that can trigger another round of bearish USD dislocation from its short-term drivers? The two most straightforward ones are the tariff and US deficit risks. Both face potential escalation in the next couple of weeks, as Trump is pushing for his One Big Beautiful Bill to be cleared by the Senate by 4 July – potentially reducing the scope for fiscal-rigour adjustments – and the 90-day 'reciprocal' tariff pause expires on 9 July. The third one is the Federal Reserve's independence: reports of Trump considering replacing Fed Chairman Jerome Powell early are hitting the dollar as we write.

EUR/USD fair value has risen thanks to dovish Fed repricing



Source: ING

Short-term rates are back on command

There is anecdotal evidence that FX hedging in USD-denominated assets has increased at a time when central banks and other large institutions may be seeking alternatives to the dollar due to Trump's policies. We believe this narrative is already largely embedded into a dollar risk premium that is unlikely to disappear entirely in the near future. Assuming concerns about Powell's removal, tariffs and the deficit do not increase that risk premium, it would be up to traditional drivers – primarily short-term rate differentials – to take EUR/USD closer to 1.20.

We are not major subscribers to the view that the ECB will stay on hold until December (a September cut is underpriced in our view), but admit that the latest hawkish communication means market pricing may not be revised significantly to the dovish side at least for some weeks. If something is to move EUR:USD rate gaps in the near term, that will most likely come from the Fed side: upcoming data and Fedspeak will offer a reality check on rising dovish bets.

Based on the latest betas in our short-term fair value model, a 20bp drop in the 2-year USD OIS with unchanged ECB pricing justifies roughly two big figures higher in EUR/USD. However, we think the impact of a dovish U-turn by the Fed could be asymmetrically negative for the dollar. That's because there is a tangible risk that markets will see a summer rate cut as a sign that Trump's dovish arguments have breached the independence shield of the Fed.

Obviously, how markets interpret an earlier-than-expected cut by the Fed would still depend on how data shapes the policy discussion. But the bar for Fed independence concerns isn't that high, and the dollar's sensitivity to the topic can spike rapidly, as we are observing now.

Our baseline scenario

Since publishing our monthly FX update on 18 June, a few things have changed in markets. Notably, geopolitical risk has been radically priced out, and most importantly, FOMC divisions have prompted material dovish speculation. This justifies a more bullish view on EUR/USD, but not necessarily a call for 1.20. Markets' enthusiasm for an earlier Fed cut may be misplaced, and EUR/USD may settle back around 1.15-1.16, awaiting conclusive information on inflation.

As discussed throughout this note, we need to see either another jump in USD risk premium (via the tariff, US deficit or Fed independence concerns) or a more dovish Fed to fundamentally justify 1.20. Those are admittedly non-negligible risks, but not part of our baseline scenario at the moment.

The underlying themes of the dollar's loss of reserve value and higher USD hedging appear, in our view, generally baked into a sticky risk premium: they can justify asymmetrically negative responses in the dollar to market events, but we aren't convinced they can take EUR/USD another 3% higher by themselves.

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