EUR/USD: Playing catch-up with $ crosses

The euro is enjoying a rally today as investors gauge the viability of plans for a €750 billion recovery fund created out of the EU's long-term budget. This EUR/USD move effectively sees the EUR playing catch-up with some other big rallies against the dollar. It's too early to say this is the start of a trend to 1.18/20, but it could turn into a 1.12 story for June

German Chancellor Angela Merkel,European Central Bank President Christine Lagarde, and European Council President Ursula von der Leyen

Source: Shutterstock

EUR plays catch-up

As we note in our latest FX Talking, we've seen pockets of strength against the dollar over the last month. These have largely been confined to the high beta, pro-cyclical currencies. Those are NOK, SEK, AUD & NZD in the G10 space, and in the emerging markets space are currencies like MXN, COP, ZAR, BRL, and RUB. Clearly here the equity rally has helped – very much supported by the turnaround in energy markets. The low-yielding EUR, JPY, CHF have done little against the dollar, while Asian FX has taken on a fragile tone (e.g. USD/CNH at its highs) as Washington assesses its next steps against China.

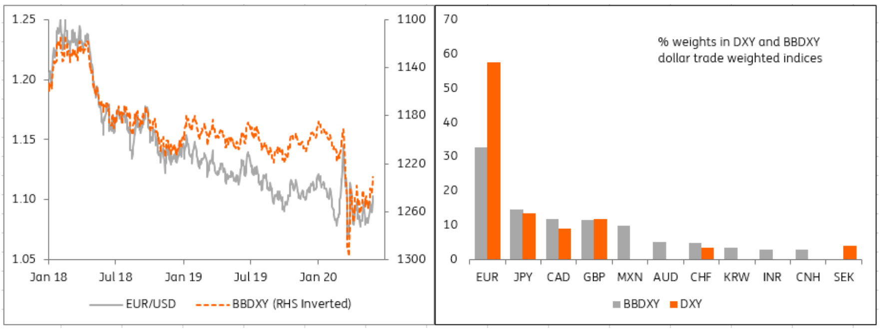
It is probably too early to say that today's rally in the EUR is the start of a major re-rating of

European risk. Certainly, the European Commission and its 'Next Generation EU' proposal would like that to be the case, but the path to getting a €750 billion recovery fund carved out of the long term EU budget will be a bumpy one, especially with EUR500bn of that fund allocated to grants. EU leaders will meet on 18/19 June to discuss these proposals in more detail and just like news on Covid-19 vaccines, there will be many highs and lows along the way. Thus it is hard to make the case that EUR/USD moves higher in a straight line from current levels.

We would say, however, if EUR/USD enjoys even a modicum of the re-rating stories enjoyed by some of the high beta currencies, 1.12 is achievable over coming weeks. This assumes that US-China does not completely derail the risk environment. We note as we write this that the AUD is under pressure on reports that China may impose coal import restrictions against Australia - again a risk our team highlighted in FX Talking.

In effect EUR/USD would just be catching up with the range breakout seen by one of the broader measures of the trade-weighted dollar, the Bloomberg Dollar Index (BBDXY). Unlike the heavily European weighted DXY dollar index, the BBDXY uses a broader number of trade weights based on trade and FX liquidity patterns. The big recoveries in currencies, like AUD, CAD, and MXN have seen the BBDXY decisively break lower and a modest EUR/USD rally would not be a surprise.

EUR/USD plays catch-up with weaker dollar index



Source: ING, Bloomberg

Broader dollar turn requires more confidence in EM

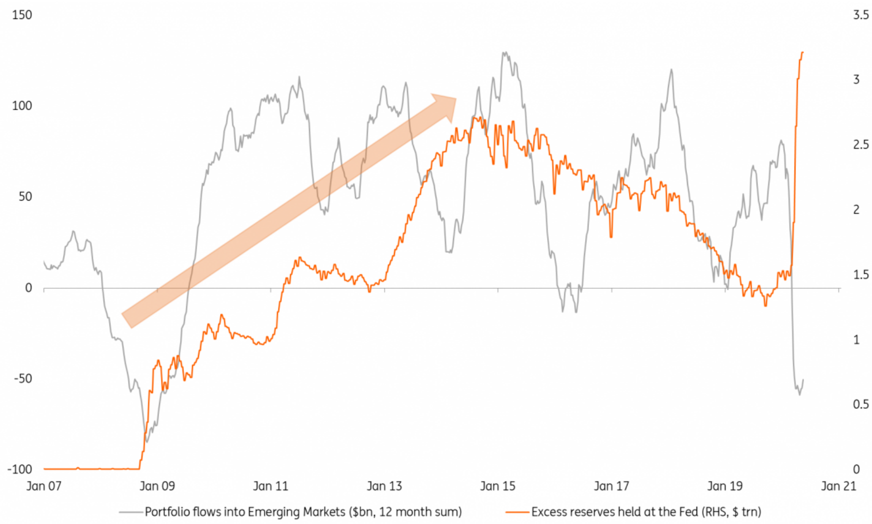
As noted above, this looks to be more of a series of re-rating stories, e.g. commodities and now Europe, as opposed to a broad turn in the dollar per se. What we would like to see is much more appetite for EM assets in general, which would help to dislodge conservative capital parked in the dollar and usher in a broader dollar decline.

We think that will happen – but it will take time. After Lehman's failure in September 2008, we did not see sustained portfolio inflows back into emerging markets until March 2009. And emerging markets, in general, were seen to be less affected by a financial crisis then than they are by the global standstill in activity now.

Yet the flood of liquidity unleashed by the Fed, as we show below now in the form of excess USD reserves US banks have parked at the Fed, should mean that EM portfolio flows re-build again later this year. This benign environment, characterised by recovery and confidence rather than trade wars and division, should allow a broader dollar bear trend to emerge and is an integral part of our call for EUR/USD to end the year at 1.20.

There are many challenges to such a scenario, but at least the threat of an immediate rise in eurozone break-up risk is probably not one of them.

EM portfolio flows versus excess dollars held at Fed



Source: ING, IIF, Bloomberg

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