

EUR/USD: Sizing up the scenarios

We know when speaking to corporate treasurers that any FX forecast comes with a health warning. When presenting FX forecasts then, research teams need to do a good job spelling out a baseline set of assumptions. Here, we detail those assumptions, but also look at an alternative range of outcomes which could see EUR/USD trading to 0.85 or 1.30 by the end of 2023



Four potential paths for EUR/USD into 2023

Making the correct call on EUR/USD over the next 18 months will depend on four key drivers:

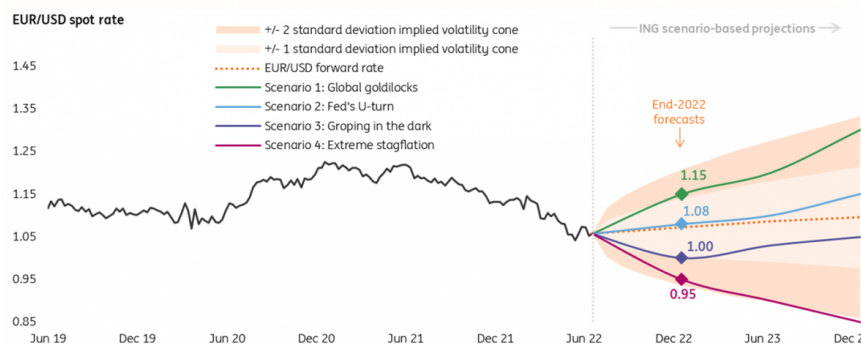
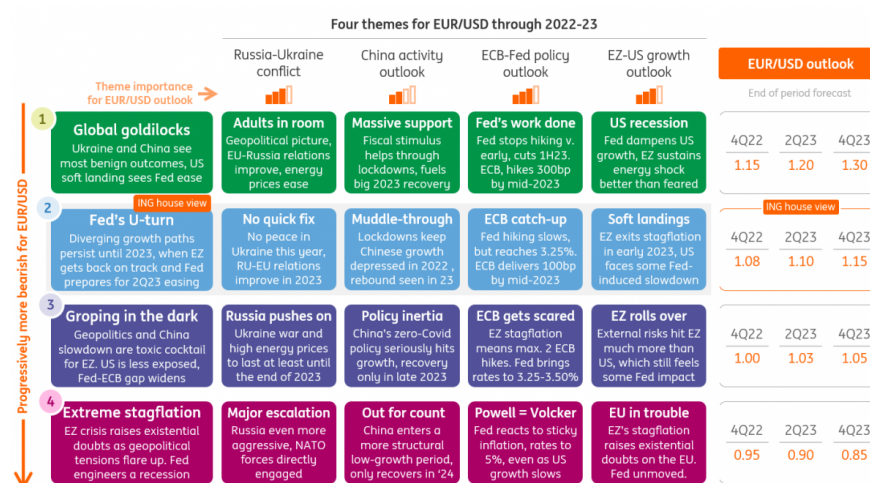
- The Russian-Ukraine war and what it means for European growth and the commodity supply shock
- Chinese growth and what it means for global demand and the global supply chain shock
- The Fed-ECB policy trade-off and to what degree it pushes differentials wider still
- US-eurozone growth prospects and what it means for global equity and FDI flows

Below we outline four scenario paths for EUR/USD into the end of 2023. We have generated the possible range of EUR/USD end-2023 outcomes using expected volatility embedded into current FX options market pricing. The extreme ranges for end-2023 EUR/USD levels, 1.30 under Scenario 1 and 0.85 under Scenario 4 derive from the two standard deviation outcomes.

Of the four scenarios presented, Scenario 2, 'Fed's U-turn' is our baseline scenario. Given that Fed policy has been such a large driver of dollar pricing since June 2021, when Fed dot plots suggested the central bank would be normalising policy after all, a Fed shift from hiking in 2022 to cutting in 2023 should take some upside pressure off the dollar. We look for a weak EUR/USD rally through 2023 as the Fed eases and some of the headwinds to growth, including China, abate.

Briefly discussing extremes, the most bullish EUR/USD story (1.30) is one of global growth recovering (somehow) in 2023 at a time when the Fed feels it can cut rates back to more neutral levels near 2.00%. The most bearish EUR/USD scenario is an early 1980s-style stagflation, where the Fed needs to continue hiking aggressively even as the global economy enters a recession. This reopens friction within the eurozone.

4 themes for EUR/USD



Source: ING

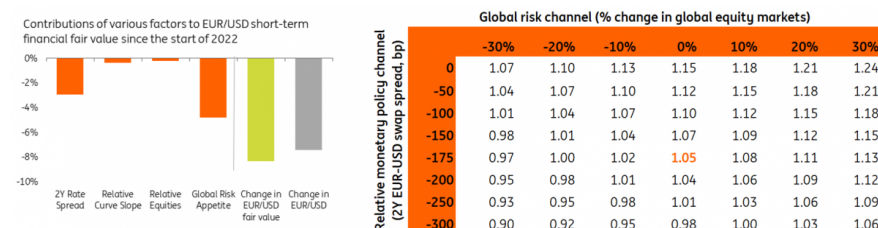
Financial fair value: Where rate spreads and equities can drag EUR/USD

Above, we have outlined some stylised scenarios of where major drivers could place EUR/USD over the next 18 months. Quantitatively, we do not think EUR/USD is particularly cheap on a medium-term fundamental basis. But other shorter-term techniques also have a quantitative say in EUR/USD pricing. Here, we use a financial fair value model to identify short-term fair value for EUR/USD.

Typically, factors like two-year EUR-USD swap spreads or the equity environment have two of the

highest betas in the model. As shown in the left-end chart below, these two factors explain nearly all the drop in EUR/USD fair value since the start of 2022, while the other two inputs in the model - the relative shape of the yield curve and relative equity performance - have had a negligible impact, displaying considerably lower betas in the model.

In the right-end chart below, we present a matrix of swap spreads versus equity outcomes - which, as discussed, are the main drivers of EUR/USD - to provide some flavour as to where EUR/USD could be trading under very different market conditions.



Source: ING, Refinitiv

It must be noted that this matrix looks at short-term dynamics, and its explanatory power over the medium term - i.e. beyond 12 months - would decrease substantially as other (longer-term) factors would start to play a bigger role.

The purpose of this matrix is to provide an indication of what combination of ECB-Fed monetary policy differential and global risk environment would be required to trigger some sizeable moves in EUR/USD over the next 12 months.

In the scenario analysis outlined at the start of this article, we considered the “global Goldilocks” scenario as the most optimistic for EUR/USD, with the pair reaching 1.20 in the next 12 months. As shown in the matrix, that would require both a rebound in global equities beyond the January 2022 peak (+30%) and a complete erosion of the ECB-Fed policy differential.

In the other extreme scenario (“extreme stagflation”), we implied a move to 0.90 by 2Q23. This would require a significant repricing higher in the Fed’s policy path relative to the ECB’s, as well as a further drop in global equities to the levels last seen in the spring of 2020.

In our base-case scenario (“Fed’s U-turn”), a return to 1.08 is achievable via a gradual recovery in risk sentiment and a stabilisation in the short-term rate differentials around current levels. Below are the details of our current quarterly forecasts.

Our forecasts and the consensus view

EUR/USD	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
ING fcast	1.05	1.05	1.08	1.10	1.12	1.13	1.15
Consensus	1.05	1.06	1.07	1.08	1.09	1.10	1.11

Source: ING, Consensus Economics

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