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:

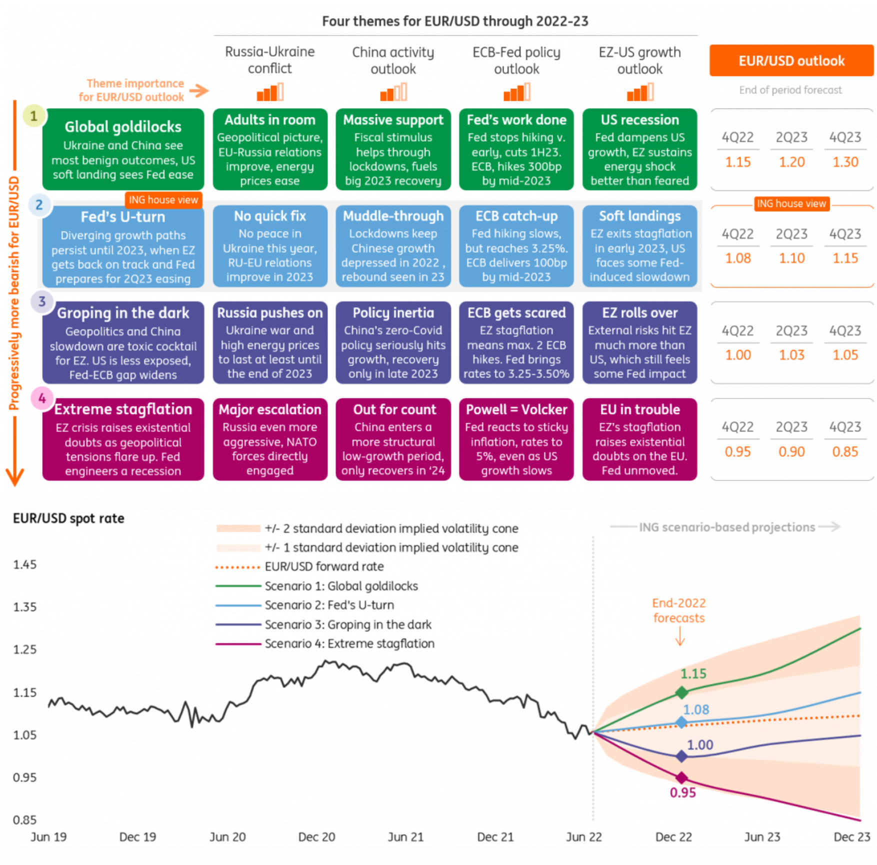
- The Russian-Ukraine war and what it means for European growth and the commodity supply shock
- Chinese growth and what it means for global demand and the global supply chain shock
- The Fed-ECB policy trade-off and to what degree it pushes differentials wider still
- US-eurozone growth prospects and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



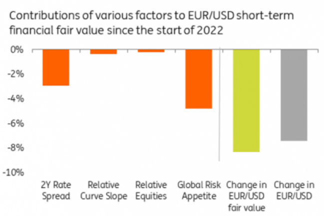
Source: ING

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.



Global risk channel (% change in global equity markets)

Relative monetary policy channel (2Y EUR-USD swap spread, bp)	-30%	-20%	-10%	0%	10%	20%	30%
0	1.07	1.10	1.13	1.15	1.18	1.21	1.24
-50	1.04	1.07	1.10	1.12	1.15	1.18	1.21
-100	1.01	1.04	1.07	1.10	1.12	1.15	1.18
-150	0.98	1.01	1.04	1.07	1.09	1.12	1.15
-175	0.97	1.00	1.02	1.05	1.08	1.11	1.13
-200	0.95	0.98	1.01	1.04	1.06	1.09	1.12
-250	0.93	0.95	0.98	1.01	1.03	1.06	1.09
-300	0.90	0.92	0.95	0.98	1.00	1.03	1.06

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 f'cast	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

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Additional information is available on request. For more information about ING Group, please visit http://www.ing.com.