# FX Daily: Double threat to the euro

French Eurosceptic candidate Le Pen seems to be closing in on President Macron in the polls. This adds another threat to the euro, which will have to deal with the announcement of fresh sanctions against Russia today. On the other hand, the dollar is enjoying good momentum as markets focus on quantitative tightening ahead of today's Fed minutes

Marine Le Pen seems to be closing in on President Emmanuel Macron in the polls

## USD: Fed minutes to unveil details on quantitative tightening

The dollar rose against all G10 peers yesterday, with the exception of the $-bloc currencies (AUD, NZD, CAD), which benefitted from a combination of rising hawkish bets on domestic central banks and a supportive commodity environment.

A key driver of USD strength yesterday was the sharp rise in US bond yields – which was exacerbated by Fed's Lael Brainard comments about the prospect of starting quantitative tightening "at a rapid pace" already at the May meeting. Incidentally, markets are finding more comfort in placing the peak of the Fed's hiking cycle around or slightly above 3.0%. Brainard's comments likely put more emphasis on the theme of quantitative tightening ahead of this evening's release of the March FOMC minutes, where indications of wide consensus within the committee to shrink the balance sheet at a fast pace could keep bonds vulnerable and support the dollar.

Despite the dollar's rally this week, our short-term fair value model shows that, for some G10 pairs (like EUR/USD), the greenback remains undervalued. This suggests the dollar still has some room to catch up with the big moves in rates (a major determinant of its short-term fair value), and we think a consolidation around these higher levels is more likely than a correction at this stage.

## EUR: French election risk premium on the rise

EUR/USD has broken below 1.0900 this morning. While the fundamental justification for a weaker euro is – in our view – undoubtful, given the recent shock to the eurozone's terms of trade, it is also true that there is mounting geopolitical risk currently being priced into the common currency. On the one hand, a new round of sanctions on Russia are expected to be announced today by the US and the EU, with any implications for energy exports likely to keep the euro under pressure. On the other hand, markets are probably only now starting to price some degree of uncertainty around the outcome of the French elections.

Recent polls on the second-round voting intentions showed that the incumbent President Macron has seen his lead over the Eurosceptic candidate Marine Le Pen to only two-three points. Indeed, Le Pen's stance on a number of EU-related issues (like an exit from the EU) has softened since the 2017 election campaign, but her impact on the stability of the EU is still perceived to be quite significant.

If we exclude the March-April 2020 Covid-induced market turmoil, the 10-year OAT-Bund spread (now at 53bp) is at the widest since the 2017 election period. Back then, the spread reached a peak of approximately 80bp. In FX, the EUR/USD 1-month implied volatility has climbed back above 9.00%, as the 1M risk reversals widened to 1.90% in favour of puts. There is an evident "kink" in the EUR/USD volatility curve around the second-round date (24 April), although all these indications of increasing political risks are quite contained compared to the 2017 vote.

We suspect there is more room for France-related political risk premium to be priced into the EUR/USD as we head to this weekend's first round. And indications from the first round votes that Le Pen might have the numbers to win in the second round would likely increase pressure to the euro next week.

When adding the potential negative spill-over from new sanctions against Russia, we see the risks to EUR/USD skewed towards the 1.0750/1.0800 area into the weekend. Any break below the 1.0817 early-March low may add fuel to the bearish run. Yesterday's decision by the EU to trigger the rule-of-law meccanism against Hungary might also contribute to keep the euro unattractive. On the data side, the eurozone calendar is quiet today, with some focus however on speeches by ECB's Guindos and Lane.

## GBP: Still no domestic inputs

EUR/GBP has now fully reversed the late-march rally, having fallen from the 0.8510 peak to the 0.8300/0.8350 area. Rising political risk in the eurozone ahead of the French elections can keep some pressure on the pair, although Cable may continue to edge lower on the back of good dollar momentum and negative impact on GBP from new sanctions against Russia. There are still no domestic drivers to GBP today.

## SEK: Downside risks prevail

SEK has seen some extra pressure this morning after the February GDP numbers showed a slowdown in growth from 4.6% to 2.5%, which was accompanied by MoM contraction in industrial production. While surely not enough to trigger a dovish re-pricing in the Riksbank's rate expectations, markets might pay increasing attention to the growth story (the inflation story argues unequivocally in favour tightening) in Sweden as the impact from the Russia-Ukraine conflict on Europe starts to unravel.

In our latest economic monthly update, we have reviewed our Riksbank call and now expect a 25bp hike in September, and acknowledge a non-negligible risk this will be followed by another hike in November. That said, we think that market's pricing for 2023-2024 (rates to rise to 2.0%+) is overly hawkish, as the tightening cycle in Sweden may peak only at around 0.75-1.0%, in our view.

For now, the prospect of 2022 Riksbank tightening is offering some support to SEK, which however seems to be embedding too little geopolitical risk and we could see a return to the 9.50/9.70 region in USD/SEK over the coming days as new sanctions to Russia are announced. Some EUR idiosyncratic weakness means a bit less upside risks in EUR/SEK, but a return to the 10.40 mark is possible.

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