

FX Daily: EUR/USD can fall to 1.16 on further Iran escalation

Large-scale US military deployment is raising the perceived risk of an imminent strike on Iran. The dollar acts more efficiently as a safe haven when geopolitical risk lifts crude prices, yet markets remain reluctant to fully price this in, leaving scope for further USD gains if escalation continues. Today's PCE, GDP and PMIs may matter less



The FX market has remained reluctant to seriously price in Iran risk

📈 USD: Ample room to rally in escalation

The rise in US-Iran tensions has wiped out most other market drivers and lent USD support amid higher oil prices. This highlights a key characteristic of the dollar in post Liberation Day markets: its safe haven appeal is generally diminished, but is fully restored when geopolitical tensions trigger oil shocks. One reason is that two alternative safe havens, EUR and JPY, are heavily dependent on energy imports and therefore become less attractive when crude prices surge.

Oil prices have closely tracked Polymarket's implied probability of a US strike on Iran by 31 March since early February. That probability has now climbed to 60%, matching levels seen at the end of January, when – much like today – Brent was trading in the \$71-72 range. If that relation holds, a 100% probability could equal a move to \$75-76. The key question for making further major crude rallies sustainable would, however, be whether Iran will block the Strait of Hormuz. That remains

only partly priced in, if Polymarket is again to be trusted: 18% by the end of March, 35% by the end of the year.

The dollar reaction has been visible, but not outsized, especially given its starting point as undervalued relative to short term fundamentals. In our view, this reflects a degree of market reluctance to fully price geopolitical risks following repeated episodes of rapid de escalation over the past year (the 2025 strikes on Iran, Venezuela, Greenland). That said, the current US military build-up in the Middle East is the largest since 2003, prompting speculation that it may be too substantial to represent a simple show of force ahead of US Iran negotiations. The UN has also warned that the US move risks closing the diplomatic window.

US President Donald Trump hinted at a 10-15 day time frame to agree on a nuclear deal, although some reports are suggesting a limited early strike is being considered. We suspect markets need to see a few encouraging headlines on diplomatic efforts and less hawkishness on the military threat to sell the dollar in this environment. It may be too early to get them today, and risks remain on the upside for USD today.

In all this, the US will release some important data today: the Fed's favourite core PCE inflation (December) and fourth-quarter GDP. We expect the former to come in at 0.3% month-on-month, in line with consensus, although we acknowledge some risks of a hotter print. For GDP, we expect 2.7% quarter-on-quarter annualised, very close to the consensus of 2.8%. If there are no new developments on Iran today, data surprises could have some impact – but should we see further oil rallies, the dollar still has much further to run regardless of the macro inputs.

Francesco Pesole

EUR: Still overvalued, major downside risks

The euro is in a poor spot when oil prices rise. What is partly mitigating losses is probably the associated risk-off in equities and the euro's recent prominence as a safe-haven alternative to the dollar.

It's not easy to estimate the impact on EUR/USD from a further oil rally, given the pair's reduced sensitivity to oil in the past year. In our current model that takes 12-month rolling betas, another \$5 rally in Brent means around 1% lower in EUR/USD, but that correlation often strengthens during oil shocks, and the risks are of an even larger selloff in the pair.

That is especially true considering EUR/USD is still trading around 1% above a short-term fair value calculated excluding oil prices (so only rates and equities). In our view, this confirms what was discussed in the USD section above – the reluctance to price in geopolitical risks. Intuitively, it means greater downside risks for EUR/USD, which we believe can trade all the way down to 1.160 in a major escalation.

On the macro side, we have eurozone PMIs today. The disappointing ZEW index this week has probably curbed some enthusiasm for today's surveys, but the eurozone composite PMI should remain well above 50.0 (expansion/contraction threshold), allowing some mild optimism. The impact on the euro should be limited, in our view.

Francesco Pesole

⬇️ GBP: Less preferable than euro

We continue to see some short-term upside potential for EUR/GBP. The current fragility in risk sentiment amid geopolitical risk should weigh more on the margin of GBP than EUR, but it's mostly domestic dynamics that should keep weighing on the pound, in our view.

We expect a rate cut at the Bank of England's March meeting, which is now 20bp priced in, and we still forecast another move in June, which is only 40% priced in. Political risk remains the other major risk for the pound.

A move past 0.880 remains our baseline for EUR/GBP.

Francesco Pesole

➡️ CAD: In a decent spot

The loonie should keep performing rather well in the crosses in the current environment. That's because it is a lower-volatility alternative in the commodity FX space, it has specific sensitivity to oil prices and some stricter correlation with USD.

We retain some concerns about upcoming USMCA renegotiations, but CAD is the only G10 currency that isn't overvalued in our short-term model vs USD, and the slightly sub-consensus Canadian CPI print earlier this week isn't enough to trigger major dovish shifts at the Bank of Canada just yet.

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