

FX Daily: Euro paying EU's isolation

Markets continue to carefully assess the implications of Russia-US talks, but we are observing an emerging trend of euro underperformance linked to Trump's growing isolationism against EU allies. With plenty of room for tariff risks to be priced into EUR/USD, we remain bearish on the pair



We are observing an emerging trend of euro underperformance linked to Trump's growing isolationism against EU allies

USD: Still room to recover

The dollar continued its rebound yesterday, although early trading today is favouring some momentum in the yen and Antipodeans. In the coming days, markets will continue to carefully assess how close a truce in Ukraine is, and crucially at what conditions. So far, Russia and the US have held bilateral discussions that have excluded both Ukraine and the EU. Hints at future Moscow-Washington cooperation can reinforce the notion of isolation for Europe from a defence and economic perspective and contribute to a rotation away from European currencies into safe haven USD and JPY. That has also been helped by Trump floating the idea of 25% tariffs on US auto, drug and chip imports overnight.

US Treasury underperformance likely helped the dollar regain some ground too. 10-year yields are back at the 4.55% mark, threatening a retest of the two highs of the past 30 days at 4.65%. We are also seeing a decline in the 30-day S&P500 - Bloomberg Dollar index correlation from the -0.60 peak a month ago to the current -0.35. In the immediate aftermath of the US election, that

correlation had turned unusually positive. The S&P500 reaching new highs yesterday did not seem to interfere with the dollar recovery.

The biggest macro event of the week is the FOMC minutes from the 29 January meeting released this evening. Markets have received multiple indications from Fed Chair Powell that there is no rush to cut rates and that the focus has shifted back to inflation concerns. We'll be looking for any assessment of the new US administration policy plans in the minutes, and risks are probably a reinforcement of the hawkish message.

Despite a more balanced picture for DXY after the past two days of dollar gains, the short-term valuation picture has not really moved back to the expensive side and the risks remain skewed to a stronger dollar in the coming days.

Francesco Pesole

📉 EUR: Weakening across the board

The rise in the German ZEW index yesterday was likely due to improved investors' sentiment ahead of expectations for a market-friendly change in government, but does not seem to mirror any real change in sentiment on growth.

The euro continues to follow sentiment on the implications of Russia-US talks, and we are starting to observe some signs of relative underperformance of European currencies that we suspect will be exacerbated by Trump's more transactional approach to European NATO allies.

Our short-term fair value model continues to show zero risk premium (i.e. undervaluation) on EUR/USD, suggesting more downside risks related to a repricing of US protectionism risk into FX. We could see the correction run until 1.040 this week.

Francesco Pesole

📉 GBP: Inflation rebound not concerning

The release of January's UK inflation data this morning has had little impact on the pound. Headline CPI accelerated to 3.0%, just above our 2.9% forecast and the consensus of 2.8%. However, this is primarily due to an unexpected surge in food prices in January, and markets are attaching little weight.

Services inflation came in marginally lower than expected at 5.0%. Although this marks a 0.6% acceleration from last month, December's figures were artificially low due to improper measurement of Christmas airfares. More significantly, our measure of core services, which excludes volatile items (including airfares) and rents, has shown steady improvement, now at 4.2%, down from 4.7% two months ago. We expect this benign trend in services inflation to persist in the second quarter and support our projection of one rate cut per quarter this year.

EUR/GBP broke below 0.8300 yesterday as the euro continued to show idiosyncratic underperformance likely linked to the EU's geopolitical isolationism relative to the US. We'd be careful picking a bottom in the pair just yet, and a move to 0.820 is not out of scope. In the longer run, we deem at least 25bp worth of dovish repricing is due in the GBP curve, which should offer some support to EUR/GBP.

Francesco Pesole

📌 NZD: Rallying on unchanged rate projections

The Reserve Bank of New Zealand (RBNZ) cut rates by 50bp to 3.75%, in line with our call and the broader market consensus. The Kiwi dollar is trading on the strong side as the Bank did not revise its terminal rate projections lower (still at 3.10%), despite retaining an optimistic view that inflation will remain within the target band and flagging growing downside risks to the economy.

The indications are that this was the last 50bp reduction, and NZD is benefitting from seeing the end of the easing cycle sooner than previously thought. Early aggressive easing by the RBNZ suggests New Zealand can be better prepared to face trade headwinds than Australia, and we still expect a gradual depreciation in AUD/NZD in the medium run.

For now, we don't think the impact on NZD/USD from a slightly less dovish than expected RBNZ will be long-lasting. As we expect a return of US trade policy as a central market theme in the coming weeks, we think the Kiwi dollar remains vulnerable. And the RBNZ's increased concerns about the growth outlook may allow some dovish repricing in the NZD curve despite the unchanged rate projections.

We expect a return to 0.56 by the end of this quarter in NZD/USD, and a move to 0.55 in the second quarter as US protectionism risk intensifies.

Francesco Pesole

Author

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@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.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

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