

FX: EUR/USD languishes

Unless eurozone growth can prompt a re-rating of European equities or longer-tenor debt spreads move substantially against the dollar, it's hard to see EUR/USD breaking out of a 1.10-15 range in the next 3-6 months. This is why we're downgrading our end 2019 and 2020 forecasts to 1.18 and 1.25 respectively

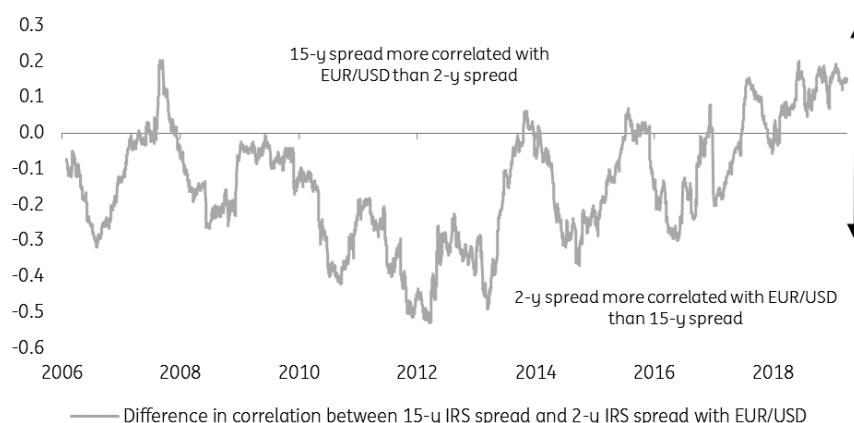


EUR/USD is languishing near the lows of the year, dogged by poor eurozone growth prospects and meagre EUR interest rates. We are still bullish EUR/USD in the medium term, but it looks like the rally will happen later and be less powerful.

One big surprise is that EUR/USD has enjoyed very little support from the sharp narrowing of EUR:USD interest rate differentials over the last few months. Given that EUR rates are rock bottom, this is really an issue of the dollar surviving the sharp decline in US rates. So what's going on?

As we highlight below, it seems as though interest differentials are increasingly driving EUR/USD at the longer end of the curve. With short term rates now looking pretty anchored on both sides of the Atlantic (the ECB's forward guidance into 2020 and the Fed with a symmetrical bias for the time being), it may well be that all the action occurs at the long end of the curve.

Longer tenor differentials having a greater say



Source: ING, Bloomberg

The problem is that even at the long end of the curve, rates are increasingly moving in sync. Thus the big drop in European rates after the dovish ECB and poor Eurozone data had a significant impact on US rates as well. Lower volatility in these spreads is reducing FX volatility, where EUR/USD traded option volatility is at the lowest level since 2014.

The lower cost of option volatility is good news for businesses looking to hedge EUR/USD exposure. Also, the fall in EUR/USD spot and the narrowing in two-year spreads provide historically attractive levels to sell dollars forward – and expensive levels to buy dollars.

EUR/USD versus 15 year swap differentials



Source: ING, Bloomberg

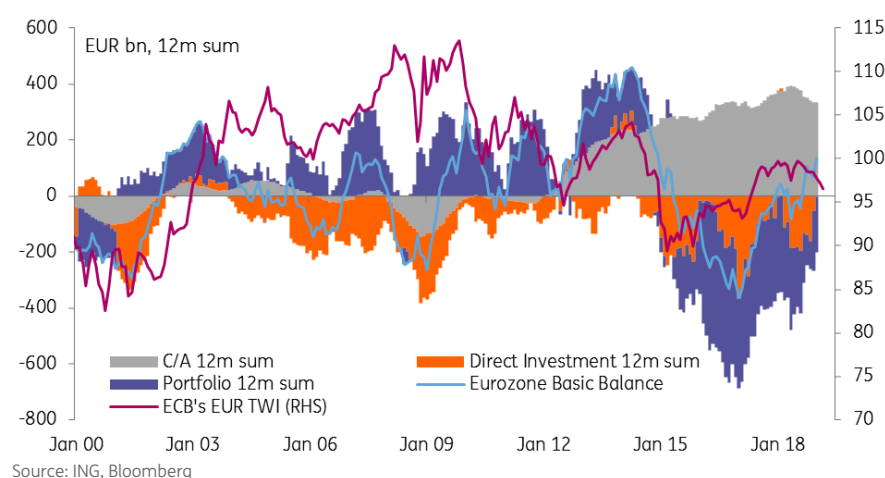
While we are bearish on the dollar in the medium term based on twin deficits, the weak eurozone position places the burden on the US to define the EUR/USD trend. Do we really know when the US will slow enough such that two year US rates start to trade 50bp under Fed Funds ahead of an imminent Fed easing cycle? The answer is probably not.

With the impact of rate differentials generally on the wane, it is probably also worth checking in on the eurozone Balance of Payment position – to get an update on flows.

As highlighted below the Basic Balance (the current account plus net FDI plus net portfolio flows) is actually looking more positive for the EUR. However, to get the kind of powerful Basic Balance position that can drive EUR substantially higher, we need to see portfolio flows to cross back into positive territory (which hasn't been the case since the ECB started QE in 2015).

Unless eurozone growth can prompt a re-rating of European equity markets or longer-tenor debt spreads move substantially against the dollar (probably via lower US rates), it is hard to see EUR/USD breaking out of a 1.10-15 range in the next 3-6 months. We are thus downgrading our end 2019 and 2020 forecasts to 1.18 and 1.25 respectively.

BoP looks more balanced for the EUR – but negative rates won't help bond flows



Author

Chris Turner

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

chris.turner@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.