FX Markets: EUR/USD parity comes into focus

April proved a perfect bullish storm for the dollar. Expectations of Fed tightening remained solid even as growth expectations were cut in Europe and China. Looking ahead, it would be foolhardy to try to pick a top in the dollar. And EUR/USD hitting parity should no longer be a shock

Source: Shutterstock

Perfect bullish storm for the dollar

There are not many months in which the dollar broadly appreciates 5% – but April was one of them. Fed tightening expectations have held up well, but events in both Europe and China have damaged the prospects for pro-cyclical currencies. Even the commodity currency bloc was hit as lower global growth prospects started to outweigh the impact of higher commodity prices. And close to US$50bn of portfolio capital has left emerging markets since Russia invaded Ukraine – again a dollar supportive story.

Given that the Fed tightening story has been a key driver of dollar strength since June 2021, it seems too early to call time on the dollar rally. It's true that financial markets are already pricing in our baseline scenario of Fed funds being taken to 3.25% into early 2023. But expectations can easily overshoot and there look plenty of opportunities for investors to briefly price an even more aggressive tightening cycle over the next six months. The Fed funds rate being priced close to

4.00% in 2023 would probably take EUR/USD close to parity.

At the same time, the uncertainty of the war in Europe and continued lockdowns in China suggest that the attractiveness of the dollar is unlikely to wane anytime soon. In fact, we are more sympathetic to the kind of boom-bust dollar trajectory seen during the 1980s.

EUR/USD parity no longer a shock

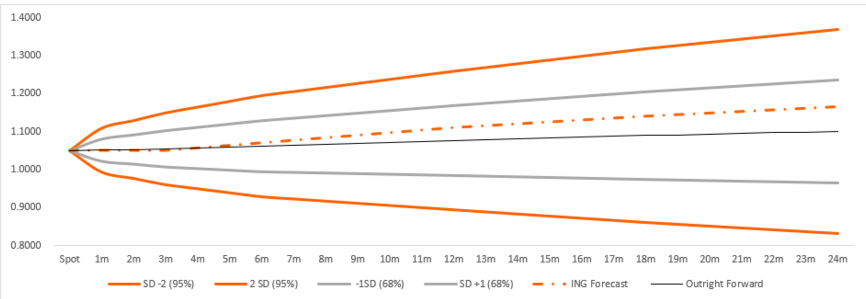
April's outsize move in FX markets has brought the EUR/USD parity scenario firmly into play. Our chart below shows a 'volatility cone' derived from the FX options market. This uses the market's pricing of expected EUR/USD volatility to portray a possible set of EUR/USD outcomes over the next two years.

Now that expected volatility is higher after recent developments, we can say that the FX options market reasonably expects EUR/USD to trade in a 1.00-1.12 range over the next six months. In other words, EUR/USD is now a one standard deviation proposition and should not be a shock.

What seems clear to us is that FX volatility will still stay high this summer and the 1.05-1.10 EUR/USD range we had foreseen perhaps now becomes a 1.00-1.10 range. Elsewhere, Japanese official concern with yen weakness suggests that FX intervention is closer at hand. Again, do not try to pick a top in USD/JPY, but the bull trend may become harder work and we do favour yen outperformance on the crosses in what should become an increasingly difficult risk environment.

And this month we are cutting our GBP profile into year-end. With regard to the expected Bank of England tightening path, there is a gulf between the expectations of the market and our UK research team. A rude awakening to a pause in the BoE tightening cycle – perhaps at the June meeting – warns that recent GBP underperformance could accelerate. EUR/GBP could hit 0.86 or higher later in the year.

EUR/USD: Range of possible outcomes expected by the FX options market



Source: ING

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