FX: Poor visibility

We are cutting our year-end EUR/USD forecast to 1.23 from 1.30

Source: Shutterstock

A cut in our EUR/USD forecast

We are cutting our year-end EUR/USD forecast to 1.23 from 1.30. We also see EUR/USD lingering around the 1.15/17 levels for longer this summer given the uncertainty of global trade policy and also the extent to which European leaders draw the sting out of Italian populism with a more conciliatory approach to immigration, for example.

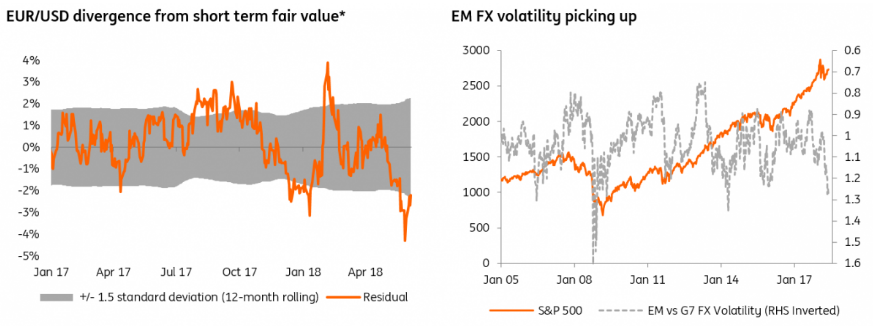
In addition to the aggressive squeeze in short dollar positions seen from April onwards, EUR/USD has also had to endure independent euro weakness on the back of Italian politics. At its peak, we estimated that EUR/USD contained a 4% European political risk premium when it was trading close to 1.15 at the height of the Italian political crisis.

Since the establishment of the European Stability Mechanism in 2012, the European political risk premium in EUR/USD has been limited to 4%, according to our calculations. But that relies on the assumption that a country in need of support is prepared to accept policy prescriptions from abroad – akin to an IMF deal. Does that assumption hold true?

For now, our team tends to see Italian risk calming as we learn how the new government plans to conduct its relationship with Brussels. An important test of this relationship will come at the 28-29 June European Council meeting in Brussels. Should the EU have something to offer Italy on migration challenges or fiscal leniency, the political risk premium in the euro may narrow somewhat.

Whether a formal ECB discussion over the end-point to quantitative easing can re-kindle independent euro strength also remains to be seen. We tend to think this is more a story for 4Q18.

EUR/USD has diverged from fair value



*Large and persistent divergence is sign of a risk premium

Source: ING, Bloomberg

Trade events could pose large risks to the EUR this summer

Instead, our bigger fears concern the path for trade policy. One of the surprises in 1Q18 was how quickly eurozone business activity and confidence slowed – in part a function of growing trade tension hitting the generally more open economies of Europe.

Unless the rest of the G7 leaders can talk President Trump down from his protectionist perch, the sequence of trade events could pose risks to the euro this summer. At present an EU retaliation to US steel tariffs looks likely in July. In which case Washington would likely follow through with its threat to impose tariffs on the EU auto industry – citing national security concerns. That would mark a severe, euro-centric escalation in the 2018 trade war. It is thus hard to rule out EUR/USD retesting 1.15 this summer.

The threat of a populist President in Mexico looks the next challenge for EM

All this comes at a time when the Federal Reserve looks intent on tightening, and idiosyncratic stories discourage investors returning to emerging markets. After Argentina, Russia and Turkey, the threat of a populist president in Mexico looks the next challenge for EM. In all, we are wary of the risk environment into July and would favour Japanese yen outperformance on the crosses.

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.