

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.

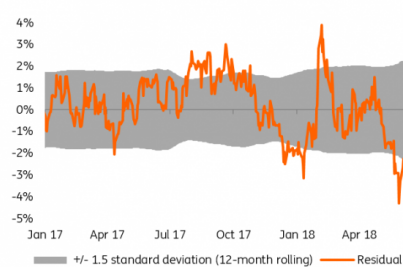
Since the establishment of the European Stability Mechanism in 2012, the European political risk premium in EUR/USD has been limited to 4%, according to our calculations. But that relies on the assumption that a country in need of support is prepared to accept policy prescriptions from abroad – akin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

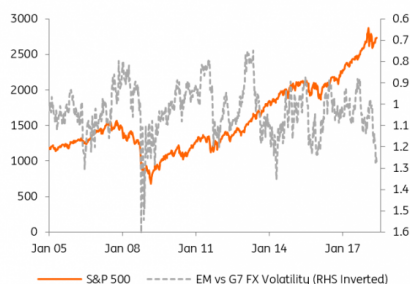
Whether a formal ECB discussion over the end-point to quantitative easing can re-ignite independent euro strength also remains to be seen. We tend to think this is more a story for 4Q18.

EUR/USD has diverged from fair value

EUR/USD divergence from short term fair value*



EM FX volatility picking up



*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.

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