

FX: Time to reconnect with rates and fundamentals

Investors have turned increasingly optimistic about a de-escalation of the Ukraine conflict. With not much geopolitical risk premium left, the FX market could start catching up with the recent shifts in rate differentials and economic fundamentals. This implies a stronger dollar, and the overvalued EUR/USD could soon slip back below 1.10



Not much geopolitical risk premium left

At the time of writing, markets are experiencing a lift in sentiment as peace talks between Russia and Ukraine seem to have opened a window for military de-escalation. It may, of course, be misjudged. But FX, markets are letting go of their defensive long dollar trades, and badly-hit European currencies are on the rise.

We acknowledge that a high degree of uncertainty remains tied to the Ukraine crisis: not just about the possibility and timing of any de-escalation, but also on the terms of a possible truce, whether (and which) sanctions on Russia could be lifted, and how the geopolitical scene in Europe will look in the aftermath of the conflict.

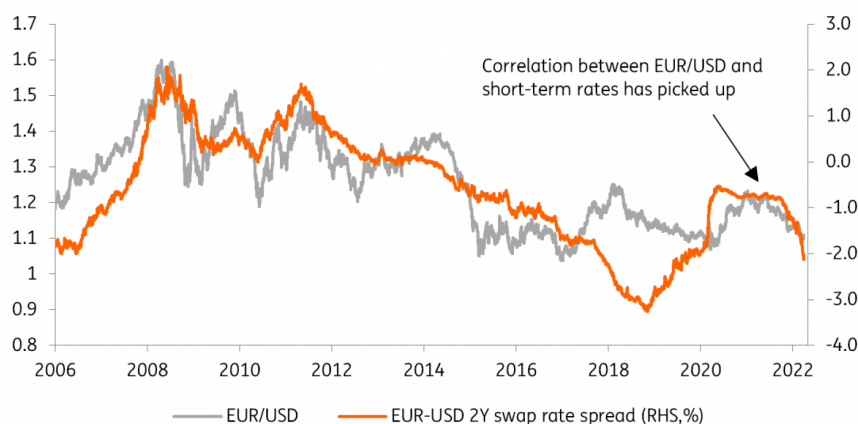
Arguably, however, it does not look like much geopolitical risk premium is left in the currency

market. The Swedish krona, a key sentiment indicator throughout the conflict, is stronger than before the invasion started. EUR/USD is only around 1.5% weaker, and that is fully attributable to ECB-Fed policy divergence.

We think that we are inching closer to a situation where the FX market gradually detaches from trading purely on the back of geopolitical developments in Russia and Ukraine, and slowly reconnects with those variables that in the longer run drive currency moves: economic fundamentals and rate differentials. And these unmistakably argue in favour of USD strength – EUR/USD weakness.

EUR/USD looks expensive in the short and medium term

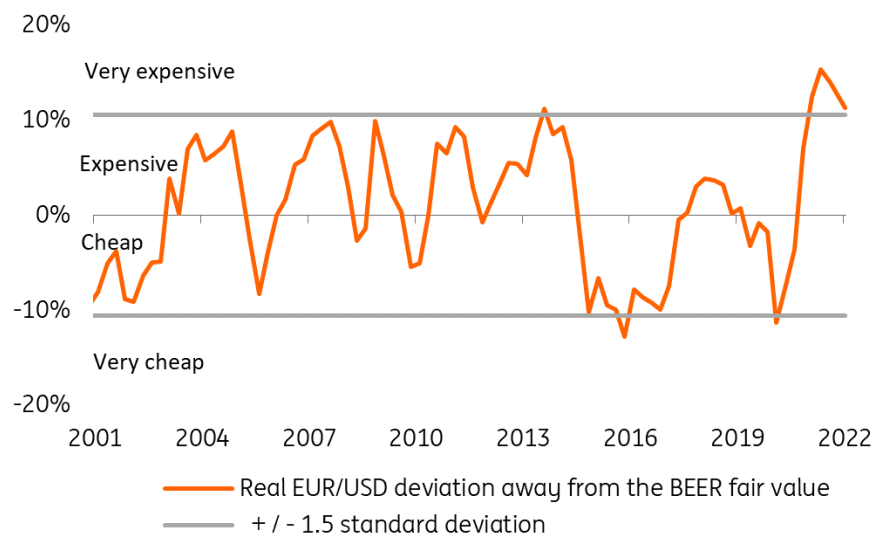
Starting with the rate divergence, the recent openness by Fed officials to 50bp rate increases has triggered a significant hawkish re-pricing in the money market. As highlighted in this Monthly economic update, our house view is that the Fed will deliver two back-to-back half-percentage hikes in May and June. This should keep hawkish expectations for the rest of the year well anchored at least into the summer and, by extension, short term USD yields elevated.



Source: ING, Refinitiv

On the other hand, the ECB will likely fall short of endorsing the 60bp of 2022 tightening currently priced into the EUR curve, and we currently forecast no rate increases before the fourth quarter. This suggests that any recovery in the depressed EUR-USD short-term swap rate differential (chart above) seems unlikely to be triggered by a further ECB hawkish re-pricing.

Another important consideration about EUR/USD concerns the economic fundamentals that generally drive currency moves in the medium term. In our Behavioural Equilibrium Exchange Rate Model (BEER), we estimate the real fair value of currency pairs using terms of trade, productivity, current account and government consumption differentials as explanatory variables. As discussed in greater detail in [“EUR/USD: Not as cheap as it looks”](#), the negative shock to the eurozone’s terms of trade caused by high energy prices has pushed EUR/USD into real overvaluation territory – in our calculations, around 11%.



Source: ING, Macrobond

Unless energy prices return to the levels we saw in the first half of 2021, which appears unlikely even if Russia-Ukraine tensions abate, any further appreciation in EUR/USD would likely bring the pair further into expensive territory. As shown in the chart above, EUR/USD has historically tended to converge back within the 1.5 standard-deviation band once it reaches a mis-valuation greater than 10%.

Our updated view on major currencies

To sum up, we expect the dollar to receive some lift-off from the Fed 50bp hikes in spring, and the overvalued (both in the short and medium-term) EUR/USD belongs, in our view, to sub 1.10 levels until the ECB initiates its own tightening cycle. We expect a move to 1.08-1.09 by the summer.

Indeed, the dollar's strength should be quite widespread, although it should mostly come to the detriment of the low-yielding currencies where the rate differentials are more pronounced. The yen has been the primary victim of a stronger dollar, where recent heavy bond market intervention from the BoJ only confirms that it is on a very different page from the Fed. We suspect that front-loaded Fed tightening and the fossil-fuel price shock will keep USD/JPY supported above 120 and the 125 area pressed again this summer.

In Europe, aside from the euro, we could see SEK give up some of its recent gains, not least due to its exposure to the economic fallout of the war. CHF may remain less vulnerable given the Swiss National Bank implicitly welcoming a stronger franc to fight inflation.

We think it is too early to call for a correction in commodity currencies, as structurally elevated commodity prices may be the legacy of this period of geopolitical turmoil. NOK and CAD may stand out, AUD and NZD could instead face a more contained upside risk (after a big run during the conflict) given their exposure to China's zero-Covid policy.

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