

## The Euro: Only as strong as its weakest link

The Italian political crisis has heaped more pressure on EUR/USD and has re-introduced the topic of a Eurozone crisis onto the FX risk map. While we cannot now rule out EUR/USD falling to the 1.10/12 area this summer, we would say that current EUR pricing already includes a substantial 4% political risk premium



Source: istock

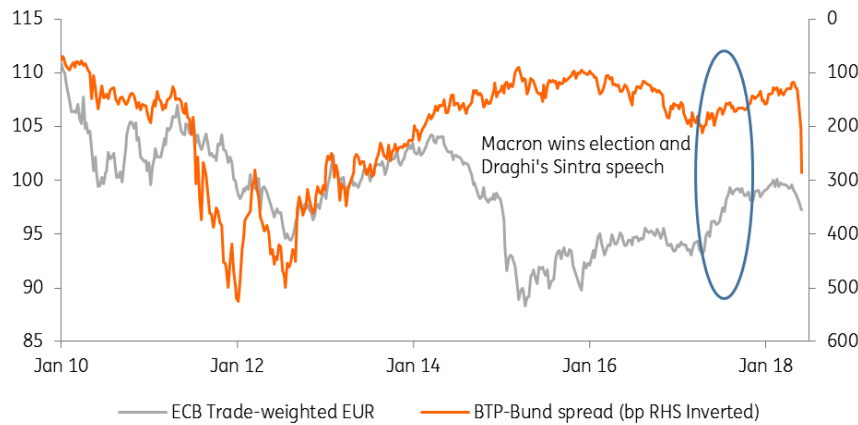
### A setback to the Euro recovery story

The 2017 rally in EUR/USD owed a large part to independent EUR strength. Emmanuel Macron had fought off the populists and demonstrated that centrists could govern after all. That success was followed by President Mario Draghi in June signalling the 'all-clear' for the Eurozone crisis and firing the starting-pistol for policy normalisation – QE tapering and then eventually rate hikes.

The Italian political crisis has proved the first major set-back to that trend. Our team feels that we're headed to new elections in the September/October window – with the prospect of the same outcome. Together, the Five Star Movement and the Northern League have 57% support in the polls and it seems unlikely that the current volatility in Italian debt markets will force them to alter course.

Despite concerns that both parties choose to radicalise their election manifestos following their choice of Finance Minister being vetoed by the President, our team feels it is too early to assume that euro-scepticism will be the core of their agendas.

## The Macron/Draghi 2017 EUR rally is under pressure



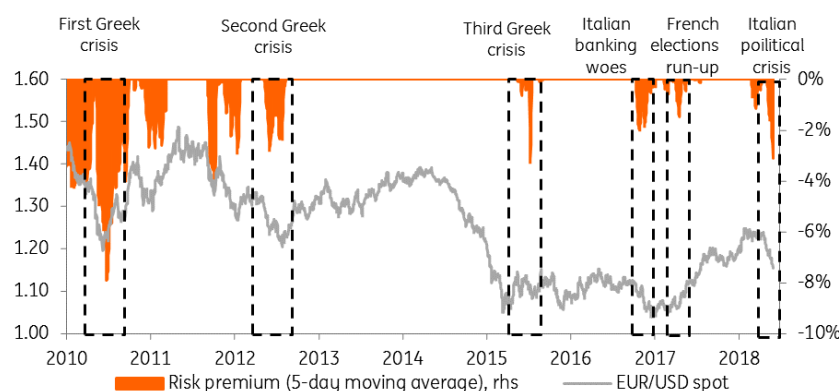
Source: Bloomberg, ING

## Euro 2H17 gains to evaporate?

Investors are already asking: 'what happens now?' Mechanisms to save the Euro such as the European Stability Mechanism (ESM) or the ECB's Outright Monetary Transactions (OMT) require a country to request financial assistance and agree to a programme – typically involving more austerity. Needless to say, it's hard to see any Italian government signing off on any more austerity right now.

On paper then it looks as though the trade-weighted EUR will fall back to levels seen last Spring, before the Macron-related rally. That means another 3% downside for the EUR, sending EUR/USD to 1.12 – all other things being equal. But a lot of bad news looks to be already in the price. What kind of further political risk premium can be built into the EUR this summer?

## Risk premium being built into the euro



\*Chart shows EUR risk premium (derived from EUR/USD financial fair value model) during the periods of EZ political crisis (we don't account for periods of the Brexit vote or the start of ECB QE and their effect on EUR)

Source: ING

## Substantial risk premium already in the EUR

We estimate that EUR/USD now trades with a substantial risk premium (worth of 4.0% based on our short-term financial fair value model, which is well outside its 1.5 standard deviation band).

This is a rather large risk premium and equivalent to the peak of the short-term EUR/USD undervaluation seen during the 2015 Greek crisis (when Greece was closest to leaving the EMU). Only back in 2010 was the risk premium larger, worth 8% on average (and peaking at 9%), as per the EUR risk premium chart above.

Should EUR/USD reflect the peak level of Eurozone political risk premium of 8% (i.e. the 2010 Greek crisis) then EUR/USD would be trading around 1.1000 level.

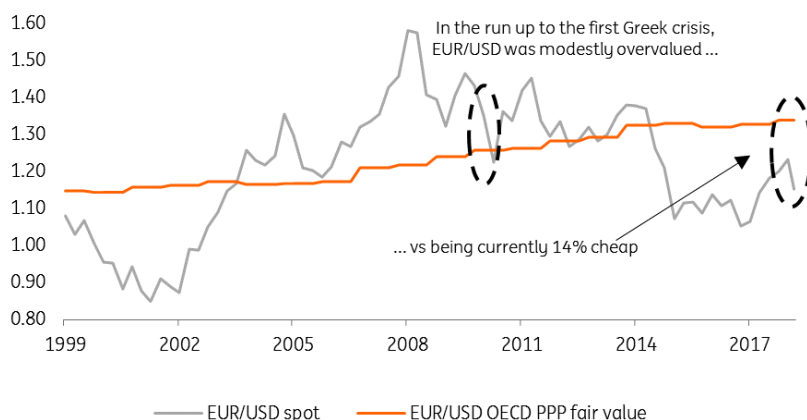
However, in our view the bar is set high for EUR/USD to endure the same level of political risk premium witnessed in 2010 because:

(a) the ECB provides a backstop via the “whatever it takes” threat (which was not the case prior to the first Greek crisis and prior to the existence of the OMT and ESM programmes)

(b) on a long-term valuation basis, EUR/USD is currently undervalued versus a modest overvaluation prior to the 2010 Greek crisis (below), which in turn should limit the scale of its potential downside

(c) the Eurozone runs a large current account (C/A) surplus (versus a flat C/A in 2010) and long-term debt portfolio flows have already left the Eurozone after three years of ECB QE - (versus modestly positive inflows in 2010). Both depicted in our final chart.

## EUR/USD very undervalued now vs the 2010 crisis



Source: ING, OECD

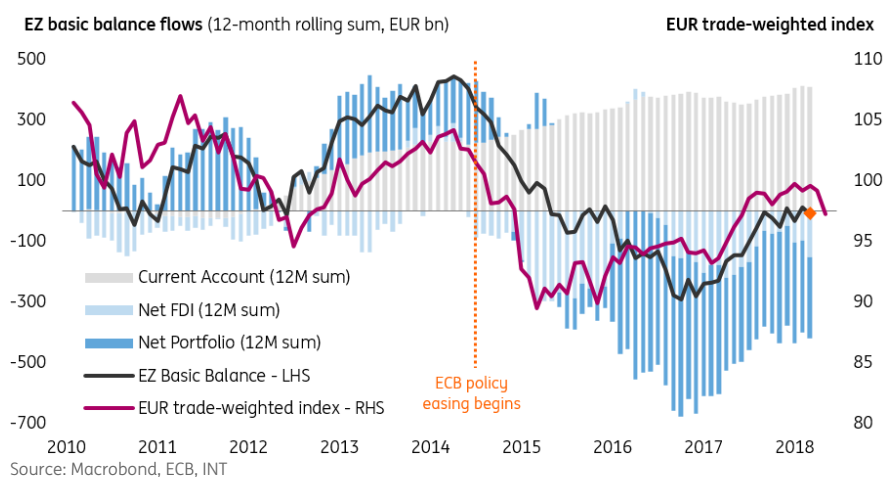
## EUR/USD at 1.10/12 requires a lot more bad news

While we cannot rule out EUR/USD trading to 1.10/12 this summer, this will probably require a lot more bad news out of Italy. In other words, things would have to look as bad as they did for Greece in 2010/12. Our team feels that Italy has a lot more to lose than Greece did at that time and thus a very eurosceptic policy agenda into fresh Italian elections is far from guaranteed. As above, the ECB backstop and the stronger Balance of Payments story also suggest EUR downside will not be

as severe as during the 2010/12 period.

That said, our 2018 baseline FX forecasts did not include this scale of Italian political crisis and our 1.30 year-end EUR/USD forecast is under review for a substantial downward revision - probably towards the low 1.20s area.

## Eurozone Balance of Payments is far more supportive of EUR now



### Author

**Chris Turner**

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

[chris.turner@ing.com](mailto: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 <http://www.ing.com>.