

When caution's not enough for the euro

With ECB tapering clearly coming, a cautious Mario Draghi was not enough to tame EUR/USD upside.



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Looking for EURUSD 1.1714 level to be tested

The ECB President, Mario Draghi, gave a cautious assessment of the eurozone's future this Thursday and gave little away on when its stimulus programme may be reduced. Despite that, we saw the euro spike higher against the dollar, yet we think a sustainable break above 1.2000 is unlikely for now.

While not dovish enough to tame EUR upside, Draghi's comments were cautious enough to limit an increase in bund yields, in turn creating a supportive environment for emerging market currencies. As long as the probability of an imminent taper tantrum bund sell-off is kept at bay, while EUR/USD continues nudging higher (via the expectations channel, rather than an actual bund move) central and eastern European FX should remain in the sweet-spot and should continue outperforming emerging market currencies.

More euro upside to come

With QE tapering clearly coming, EUR remains attractive for the forward looking market participants as more upside potential to German bund yields, once the ECB more formally hints at

policy normalisation, still remains in place (towards 0.65-0.70% levels for 10yr bund) and should further support the undervalued EUR/USD. Indeed, we are currently seeing what appears to be a repeat of the situation after the French elections where EUR/USD started to trade with a persistent ECB QE taper premium, pricing in the 'event' well ahead of the bond market.

We continue to expect EUR/USD to overshoot our 1.15 target, towards the 1.17 level.

At this point, we see a sustainable break above the 1.2000 level unlikely, particularly after Draghi's comments on unwanted tightening of eurozone financial conditions that would jeopardise the inflation outlook. We only expect EUR/USD sustainably to reach the 1.20 level in mid-2018, once QE tapering approaches its end and the forward looking market participants start pricing in normalisation of the ECB deposit rate. Nonetheless, there is more near-term EUR/USD upside to come.

CEE FX in the sweetspot

While EUR/USD is driven higher by currency market participants preparing for the higher bund yield effect on the euro, central and eastern European currencies remain in the sweet-spot. There are two reasons for this:

- The currency block is the only emerging market region benefiting from higher EUR/USD
- The lack of disorderly moves in local bond markets will keep CEE FX supported against the euro.

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