EUR/USD: Macro and geopolitics align for a downside breakout

Today's release of softer-than-expected eurozone PMIs have proved the catalyst for EUR/USD to break to the downside of its two-year trading range. Even though a near 7% drop in just two months is an exceptionally quick move by historic standards, a lower EUR/USD remains a conviction call. We don't see too much support ahead of 1.0190/0200 now

Today's soft eurozone PMIs have sent EUR/USD to two-year lows

Breakout

As many had been fearing and our team had been writing this week, today's softer-than-expected European PMI numbers have proved the catalyst for a downside breakout in the euro. The numbers feed into the narrative that European business confidence is crumbling – or at least sees no way out of stagnation – in an environment of looming trade wars and political gridlock in Europe.

Our team have been saying it for a while now, but it looks like European Central Bank rate cuts will have to do the heavy lifting again when it comes to supporting the eurozone economy. Today's data triggered an 8-10bp drop in short-dated eurozone swap rates, pushing the 'Atlantic' rate differential to the widest levels of the year. The market is now starting to lean towards our house view of a 50bp ECB rate cut in December and bake in a sub-neutral 1.75% ECB policy rate for next summer.

When we lowered our EUR/USD forecasts earlier this month, this was largely on the view that US:eurozone rate spreads would widen and a risk premium from trade wars would be built in later in 2025. Actually, we're having an internal debate as to whether that risk premium should be built in earlier.

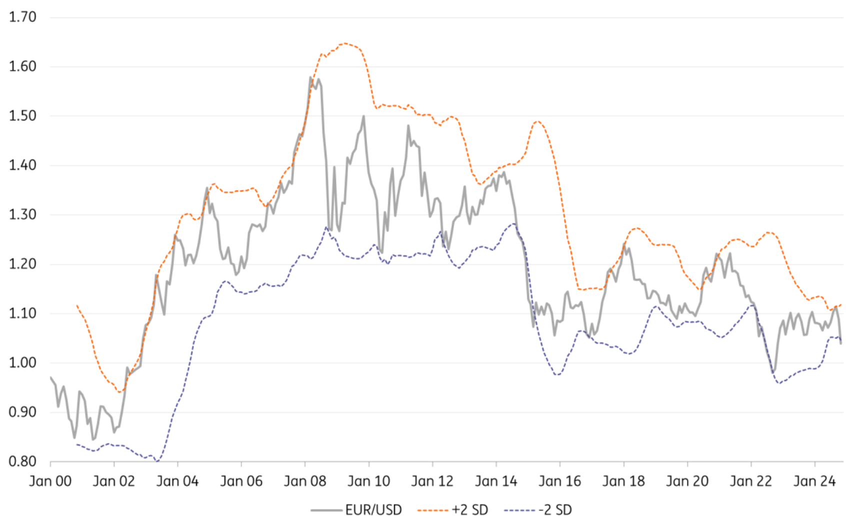
At the same time, the escalation in the Russia-Ukraine war this week has added to euro downside. The understandable fear now is that this crisis escalates into year-end as both sides try to secure the best possible positioning ahead of potential Trump-led ceasefire discussions in January. Unlike in 2022, energy prices have been remarkably subdued, although we are starting to see European natural gas prices creep higher again – a clear negative for European currencies.

The two main arguments against much further EUR/USD downside are that EUR/USD has come a long way already and that the dollar normally weakens in December. On the former, the near 7% drop in just two months is exceptional. Could this fire up the ECB hawks who might be worried about imported inflation, or least prompt some kind of comments from ECB officials about a speed of adjustment that has been too quick for European businesses? We would not rule it out, but at most such comments should slow not reverse the current EUR/USD drop.

How far could EUR/USD fall? As Francesco Pesole wrote yesterday, EUR/USD is now a little undervalued based on our medium-term BEER model – but that doesn't preclude a move to parity. Now that the 2023 1.0448 EUR/USD low has been broken, we certainly see scope to the next support zone down at 1.0190/0200.

And in terms of positioning, our colleagues in the FX Options team suggest that investors might not be as short EUR/USD as much as they had hoped after downside barriers have been triggered today – these barriers having been used to cheapen downside FX options structures but, by being triggered, have now cancelled those downside EUR/USD structures altogether.

EUR/USD breaks to the downside of exceptionally tight range



Source: Refinitiv, ING

Volatility regime change?

The narrow EUR/USD ranges of the last two years have been the exception rather than the rule. And it is tempting to say that the advent of Trump 2.0 – or Trump unleashed, as many commentators are calling it – can usher in a period of higher volatility. Certainly the EUR/USD FX options market is taking note and has pushed one year EUR/USD traded volatility up to the highest levels since October.

What holds us back from concluding that yes, we expect structurally higher levels of FX volatility in 2025, is that the peak Trump trade wars of 2018-2019 saw EUR/USD traded volatility actually decline. Here, it seems investors got used to Trump protectionism back in 2018/19. The difference in 2025, however, is that we could be talking a global trade war and not just protectionism against China, which was the case in 2018-19.

We also note in the chart above that EUR/USD is breaking to the downside from a historically low volatility environment – a warning of a volatility regime change.

Given the heavy macro/geopolitical factors favouring the downside and the fact that EUR/USD is not particularly undervalued based on our medium term models, we certainly do not want to stand in the way of a EUR/USD move to parity nor fight the rise in higher traded volatility levels.

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