Temporary reprieve for USD

The recent EUR/USD correction below 1.20 looks to have been driven more from the dollar side.

Source: istock

What happened?

Greater confidence in a December Fed rate has pushed short-term interest rate spreads to new wides – at a time when the market was positioned heavily short the dollar. Yet we very much view the EUR/USD sell-off as a bull market correction. We continue to see the 1.15/17 area as the low end of a multi-quarter trading range.

1.20 EUR/USD correction

Past comparison

At various times this year, different maturities of the euro versus dollar yield spread have determined EUR/USD pricing. In July and August, the sharp narrowing in 10-year spreads (led by higher Bund yields) was the story. Over the last month it has been the widening of short-end spreads – driven by confident Fed policy – that has weighed on EUR/USD.

What next?

Barring a major escalation in the Korean dispute or a very credible Trump tax plan, the biggest driver of EUR/USD this month should be the ECB meeting on 26 October. The ECB will have to tread the narrow path between forward guidance to keep monetary conditions in check, whilst at the same time addressing genuine scarcity issues in its PSPP bond purchasing programme.

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Our sense is that the ECB may not be as worried about euro strength as the market believes. Instead we suspect that investors and the long end will react more to the large cut in PSPP monthly purchases, than the euro short end reacts to forward guidance that the ECB does not raise policy rates until late 2018 or early 2019. This scenario could potentially be very positive for the euro.

At the same time the market looks well on its way to pricing a December Fed hike and has already priced one of the further two 25bp hikes we expect in 2019. A major rise in the US yield curve is not a given from here. Instead, debate over Yellen's succession plus fresh concerns over the US debt ceiling in December could actually see US yields retrace.

Our conclusion

In all we remain very comfortable with our above consensus call of EUR/USD ending 2018 at 1.30 – having consolidated around the 1.20 area in 4Q17/1Q18. The softish dollar story should also be welcome news to the Trump Administration in a mid-term election year – especially with the threat of protectionism looming ever larger.

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