

EUR: ECB's path of least resistance is a 'gradual' rally

With the Euro rising to a 3-year high against the US dollar, it's worth reiterating the ECB's path of least resistance will be a *gradual* rally in towards 1.30



Source: istock

The only way is up for the euro... but gradually

- While we were expecting stability in EUR/USD around the 1.20 level over the coming months – given the lack of obvious directional catalysts - yesterday's hawkish ECB minutes were a bit of a curveball. Still muted Eurozone inflation data and the run-up to the Italian elections "should" act as limiting factors for the euro – although, in a weak dollar environment, further EUR/USD upside cannot be ruled out.
- The technical correction lower in EUR/USD that was in place before yesterday's ECB minutes had not masked the broader fundamental reasons for a stronger EUR in 2018: (1) above-potential Eurozone growth, (2) greater European integration, (3) structural and financial reforms and – most importantly – (4) the markets' general underestimation of the

pace and extent of ECB policy normalisation.

- **All of this means that we're looking for EUR/USD to gravitate towards 1.30 by end-2018 – and for us, it's more a question of how, not if, we get there.**
- **The ECB's path of least resistance will be a gradual appreciation in the EUR.** Our estimates show that the central bank's 'pain threshold' – that is the point at which currency appreciation starts to weigh on the real economy – is a sharp move above 1.25 this side of summer. Any negative effects would be exacerbated if we also saw an overall tightening of financial conditions (ie, higher bond yields and lower equity prices).
- **With policymakers likely to be wary of this - we had expected to see fairly neutral ECB rhetoric in the first half of the year.** Yesterday's ECB minutes were a bit of a curveball here – but still should not be over-exaggerated in terms of what this means for policy. A gradual normalisation in Eurozone financial conditions is the policy optimal.
- **The easing of short-term political risks and a resilient Eurozone economy should give way to a higher EUR.** We expect forward-looking FX markets to price in the ECB's next policy steps this summer (call it Sintra Part II)– and that will see EUR/USD trading at 1.25.
- **While the USD's role as a global currency may start to come into question, one story we could see making a comeback in 2018 is greater sentiment for the EUR as a reserve currency.** Since 2010 – we've seen the share of EUR reserves held by global central banks fall from 28% to below 20%. This is a pretty big move for something that is usually quite static over time. Eurozone political risks and the slower post-crisis economic recovery were two factors behind this decline; but with both of these set to reverse course in 2018 – there's a strong chance you'll start to see real money investors once again favouring the EUR as a safe, investment currency.

For even more detail on this, check out Viraj's note on the 'January FX Blues' [here](#)