EUR: Embrace the strong euro

- **The EUR has changed and we should embrace it. It is no longer priced as a tail risk currency. With the ECB policy normalisation at its start, there is a plenty of upside**
- **The next big thing will be the moment when the market positions for the higher ECB deposit rate. This is not priced in yet**
- **We look for the EUR/USD to break above 1.25 and test the 1.30 level in 2018**

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As the key EUR driver, we continue to focus on the European Central Bank's (ECB) two-step exit from its current ultra-loose unorthodox policy stance, translating into two discrete jumps in EUR/USD higher.

Discrete jump No.1 underway: QE tapering

While we think the bulk of the ECB QE taper expectations is already in the EUR price (FX markets heavily front run the Eurozone bond and rates market), still we look for the very last leg of QE taper-led EUR strength in 2Q-3Q 2018 as the ECB decides on the future of QE either during the June or July policy meetings.

With bund yields still very compressed (following the ECB's successful attempt to cool QE taper expectations in the October meeting) and likely to remain compressed until the Italian elections in March 2018 (and as was the case ahead the French Presidential elections earlier in 2017), there is room for a possible bund tantrum-like price action and a higher EUR.

Our economists tentatively expect the ECB to announce an extension of QE by an additional quarter and halving the purchases to €15bn in 4Q18. However, this should not derail the underlying message: *QE is ending, stay long EUR.*

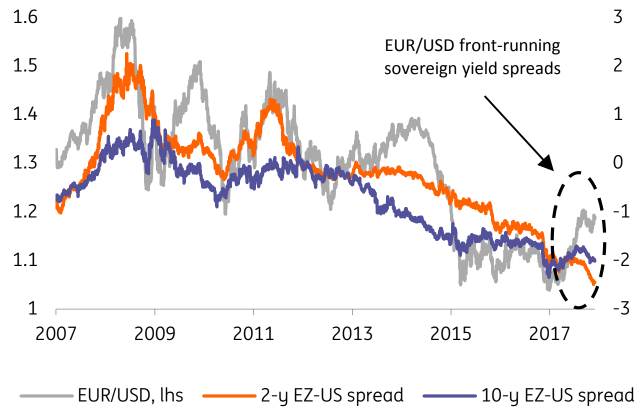
> *"We don't rule out a scenario whereby ECB QE purchases will end in October 2018"*

We don't rule out a scenario whereby ECB QE purchases will end in October 2018. With the Eurozone economy doing well (our economists see upside risks to their 2018 growth forecast of 2.2% YoY), activity indicators are strong and CPI is expected to stay around 1.4% YoY in 2018 (i.e., no risk of deflation) the dissent within the ECB Governing Council to the QE extension should rise (as per the October Meeting Minutes).

The sooner QE ends, the sooner the market will position for the second (not yet priced in) leg of the ECB policy normalisation – the rise in the ECB deposit rate (which is now the relevant policy rate given the excess liquidity generated by the QE).

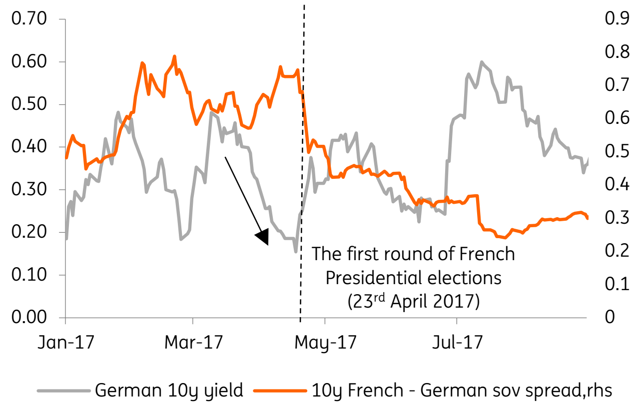
1.30 ECB QE taper expectations are already, for the most part, reflected in the EUR price but the second step of the ECB policy normalisation, should bring EUR/USD towards 1.30 in late-2018.

EUR/USD front-run the yield spreads



Source: Bloomberg, ING

Bund yields not to rise ahead of Italian elections



Source: Bloomberg, ING

Deposit rate normalisation: Discrete jump No.2 still to come

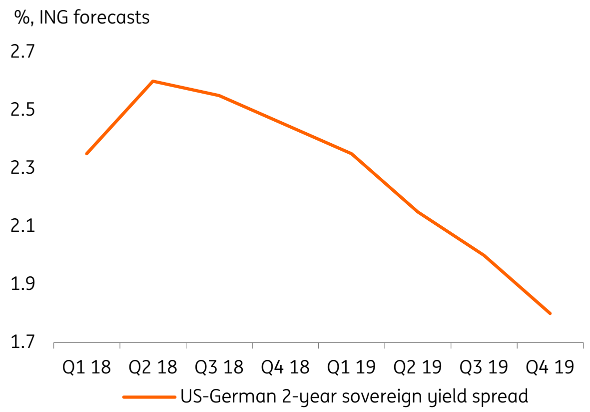
> *“FX market is likely to position for the deposit rate normalisation well ahead of the event”*

We expect the ECB to fully stick to the notion of sequencing whereby the deposit rate will be lifted only after the active QE purchases stop and with some delay.

Our economists expect a first depo rate hike (by 20bp) around mid-2019 and the depo rate to reach zero by end-2019. However, as was the case with the ECB QE tapering, the FX market is likely to position for/price in the deposit rate normalisation well ahead of the event.

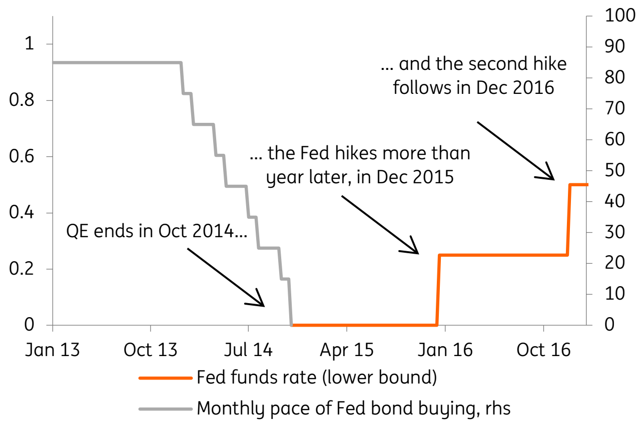
In our view, this should happen in 2H18 once it becomes clear that the ECB QE is to stop by the year-end. With the 2yr Schatz yield currently trading at -0.70%, it clearly shows that the scope for re-pricing (and thus higher EUR) is immense, causing the second discrete jump in EUR/USD higher and bring EUR/USD towards the 1.30 level next year.

Short-end yield spread to benefit EUR



Source: ING

The initial stage of Fed normalisation took too long



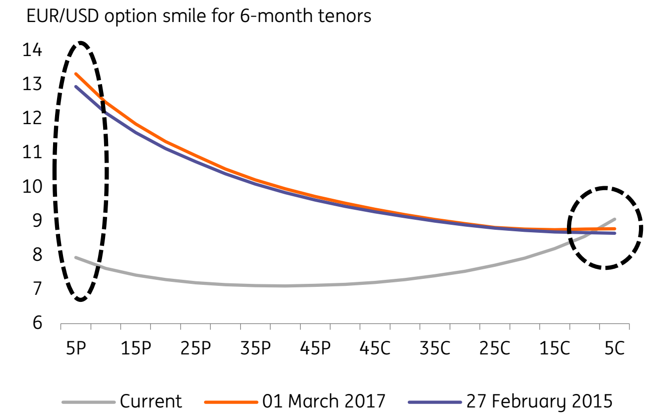
Source: Bloomberg, ING

> *“2-year US-Eurozone sovereign yield differential should start narrowing materially”*

Indeed, with the Fed hiking cycle being in a mature stage and closer to its peak by the end of 2018 and the meaningful scope for a rise in short-end German Schatz yields, there is plenty of room for a short-end rate spread-led EUR/USD rise.

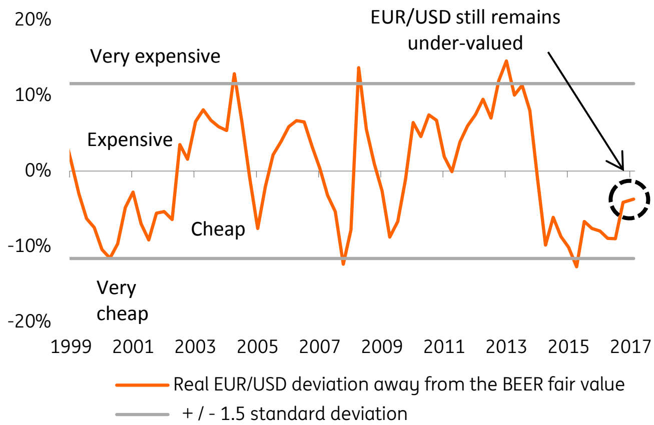
The figure below shows that from 2Q18 onwards the 2-year US-Eurozone sovereign yield differential should start narrowing materially as Eurozone short-end yields start catching up with those in the US. With EUR/USD historically being a short-end rates driven cross (and both central banks no longer engaging in active balance sheet expansions by the time), this points to a clear upside to the pair.

Structural change in the perception of EUR/USD



Source: ING, Bloomberg

EUR/USD still cheap on a medium-term basis



Source: ING

We also note that the transition away from QE purchases into the normalisation of the policy rate should be initially faster in the Eurozone than was the case in the US. In the US, it took the Fed more than a year to hike the policy rate (December 2015) after QE tapering ended (October 2014). The second hike in December 2016 followed the first rate hike by a year too. In the Eurozone, we expect 40bp of tightening (bringing the deposit rate towards zero) to occur within one year after the end of QE. The faster initial pace of the tightening after the end of QE should also be EUR positive.

Italian elections: Cautiously looking through

As was the case during the 2015 Greek crisis, 4Q16 Italian banking woes and 2017 French Presidential elections, the run-up to Italian elections shouldn't be overly EUR negative. In all these instances, EUR/USD was rather immune from the negative headline news. We expect more of the same, with the event preventing EUR from rallying sharply (as the uncertainty will cap the upside to bund yields) rather than actively pushing it lower.

> *“ EUR no longer seen as a tail risk currency ”*

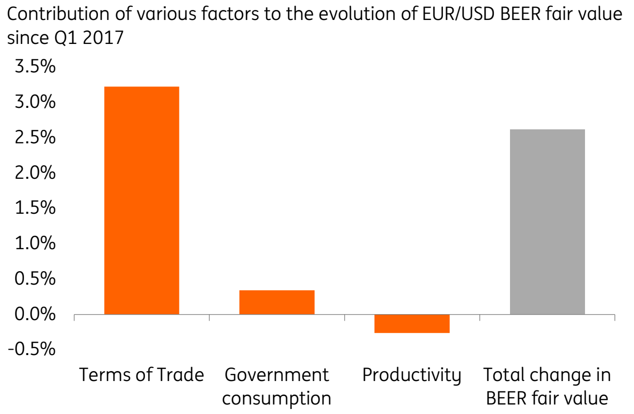
Indeed, since the 2017 French elections, the perception of EUR/USD has changed dramatically, with investors fully accounting for the change in dynamics of the cross. The waning impact of potential political Eurozone risk events, strong rebound in Eurozone growth, stabilising inflation and the upcoming ECB policy normalisation has removed the perception of EUR being a tail risk currency. This is clear in the figure below, which shows a sharp change in the EUR/USD option smile. Negative tail risk was priced out and mildly positive structural upside is being priced in. The EUR has changed and we should embrace it.

Valuation: Still undervalued EUR, despite the big rally

> *“ EUR/USD remains undervalued both on a medium- and long-term basis... ”*

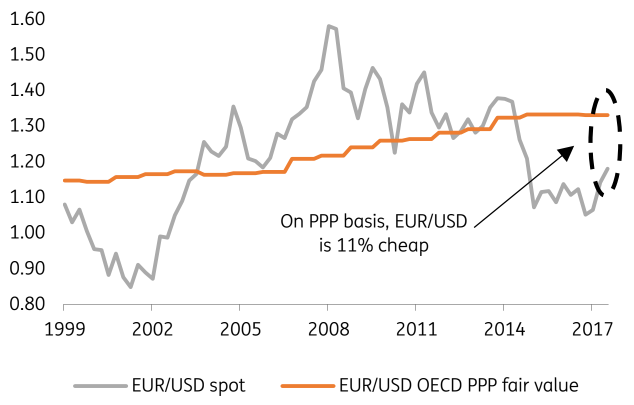
Although the extreme EUR/USD valuation gap partly corrected this year following the close to 15 big figures EUR/USD rally, we note that the cross remains undervalued both on a medium- and long-term basis. Our medium-term BEER fair value model still points to around 4% EUR cheapness. This means that EUR/USD still has a long way to go before becoming stretched on the overvalued side. Moreover, we also note that the EUR/USD BEER fair value started rising (by 2.6% since 1Q17 as the Terms or Trade differential moved into the euro's favour) and may continue to do so in the coming quarters. The increasing EUR/USD BEER fair value raises the bar for EUR/USD to become meaningfully expensive, thus providing breathing room for further EUR/USD gains.

Terms of Trade raised EUR/USD fair value in 2017



Source: ING

EUR/USD remains well below its long-term fair value



Source: ING, OECD

On a long-term basis (based on the OECD PPP model), EUR/USD remains significantly undervalued, with the OECD fair value estimate being at 1.33. Coupled with the sharply improving domestic economic outlook and the ECB's first steps towards policy normalisation, this suggests clear scope for a multi-year EUR/USD upside.

> *"...but a less extreme mis-valuation means lower scope for extreme moves"*

Although the valuation still points to further EUR/USD gains, given that the valuation gap is now less extreme, we look for a more orderly pace of EUR/USD appreciation next year compared with the 15 big figure moves over 4-5 months observed earlier this year. Indeed, a less extreme mis-valuation means lower scope for extreme moves.

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