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EUR/USD: What's next?

Scenario analysis based on 4 macro & political themes

EUR/USD has confounded consensus expectations this year, hit by both intermittent episodes of USD strength and EUR weakness. Of the many factors that will drive EUR/USD over the next 12-18 months, four stand out: (i) Trade wars; (ii) European politics; (iii) the relative ECB/Fed policy outlook; and (iv) the relative EZ-US growth (and equity) prospects. Below we outline our baseline and alternative assumptions for these inputs – and our corresponding baseline and alternative EUR/USD profiles.

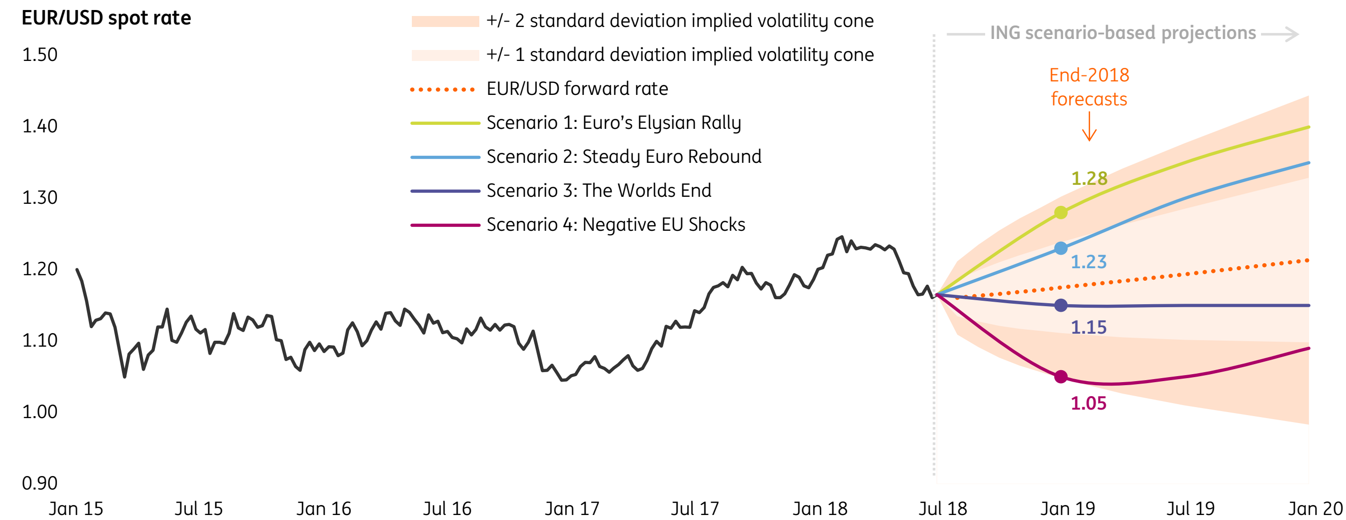
The landscape for global markets is pretty murky but here are four potential EUR/USD paths

Four themes for EUR/USD over the next 12 months

Theme importance for EUR/USD outlook

Progressively more bearish for EUR/USD

Scenario	Trade wars & protectionism	Political climate in Europe	Relative ECB-Fed policy outlook	Relative EZ-US growth outlook	EUR/USD outlook (End of period forecast) 4Q18	2Q19	4Q19
1 **Euro's Elysian Rally** Reduction in external risks invigorates solid Eurozone cyclical economic forces	**Tariff ceasefire** White House takes a step back from its protectionist bias	**'Merkron' revival** Fresh reform drive in Europe & stable Italian government	**Hawkish ECB** Early summer 2019 ECB hike risks; Fed hiking cycle priced	**Rotation into EZ** Overseas investors see value in Europe as growth recovers	1.28	1.35	1.40
2 **Steady Euro Rebound** (ING house view) Euro sees right through Trump's tariff bluffs & re-couples with solid economy	**Dangling threats** Risk of auto tariffs & investment curbs but no escalation	**Political stability** Merkel resolves CSU issues; Italy also given concessions	**Slow and steady** ECB still ends QE in 2018 and short-end EUR rates rise	**Stable outlook** Eurozone equity outflows abate as activity stabilises	1.23	1.30	1.35
3 **The World's End** EZ politics on a knife-edge but all-out trade war and a dovish Fed limits $ upside	**All-out trade war** Slowdown in global trade elicits broad market sell-off	**Risks flare-up** Risk of fresh Italian elections; Merkel struggles to govern	**Global easing** Fed dovish U-turn; ECB extends QE through to 2019	**Flight-to-safety** Investors pile into debt; large external surplus supports €	1.15	1.15	1.15
4 **Negative EU Shocks** Euro dumped as Trump targets EU car sector while EZ politics is in disarray	**US protects cars** US puts tariffs on car imports but no RoW retaliation	**A lost EU cause** Merkel leaves, EU left leaderless; Italy issues mini-BoTs	**Hawkish Fed** Upside risks to USD rates; ECB hike bets pushed out to 2020	**'Sell Eurozone'** Eurozone equities sold (local risks); US assets outperform	1.05	1.05	1.10



Source: ING, Bloomberg.

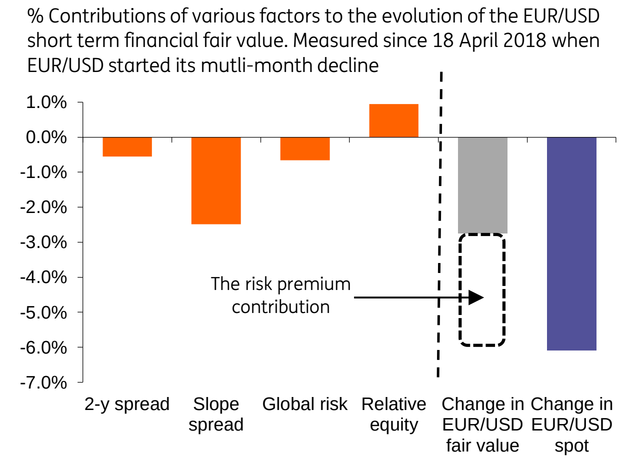
Breaking down the drivers for EUR/USD

EUR/USD decline since mid-April has been in large part driven by a rising risk premium

The EUR/USD decline since mid-April (when the cross embarked on a sustained depreciation trend) has been in large part driven by a rising risk premium. This is depicted in Figure 1 which shows the change in the short term EUR/USD financial fair value, (FFV) its contributing factors and the actual move in the spot.

While EUR/USD declined by 6% over the time horizon, its fair value fell by only 3%, meaning that the remaining 3% was driven by other factors – or the risk premium as we call it. The emergence of the risk premium coincided with the Italian political crisis.

Fig 1 Risk premium a big driver behind the EUR/USD fall



Source: ING estimates, Bloomberg

Fig 2 The risk appetite vs relative monetary outlook puzzle

Global risk channel (% change in global equity markets)

Relative monetary policy channel (2-year EZ-US swap spread, in bps)	-30%	-20%	-10%	0%	10%	20%	30%
-150	1.12	1.18	1.23	1.29	1.33	1.38	1.42
-200	1.08	1.14	1.19	1.24	1.29	1.34	1.38
-250	1.05	1.10	1.15	1.20	1.25	1.29	1.33
-300	1.01	1.07	1.12	**1.16**	1.21	1.25	1.29
-350	0.98	1.03	1.08	1.13	1.17	1.21	1.25
-400	0.95	1.00	1.04	1.09	1.13	1.17	1.21
-450	0.92	0.96	1.01	1.05	1.09	1.13	1.17

Source: ING estimates, Bloomberg

As per the above, our FFV analysis only explains half of the 6% decline in the EUR – with the remainder being the risk premium. But of the explanatory factors in the FFV, Figure 2 presents a matrix of outcomes using two of the key inputs to the model: the 2-year EZ-US rate spread and the risk environment (represented by the MSCI World equity index).

We choose to look at these two inputs since: (i) this year has seen a dramatic re-connection between EUR/USD and rates spreads and (ii) protectionism and the risk of a sharp slow-down warns that global equity markets will now be very much in focus.

Within our matrix, one can assess various EUR/USD scenarios depending on the shifts in the risk appetite

Within our matrix, one can assess various scenarios depending on the shifts in the risk appetite (i.e. a full blown trade war) and its impact on the relative rate outlook (i.e., a potential dovish re-pricing of the Fed). For example, should we see a 30% collapse in global equity markets (horizontal axis) and narrowing 2-year rate differential from -300bp to -250bp (vertical axis), the simple model based approach would suggest EUR/USD trading at around 1.05 (as per Figure 2).

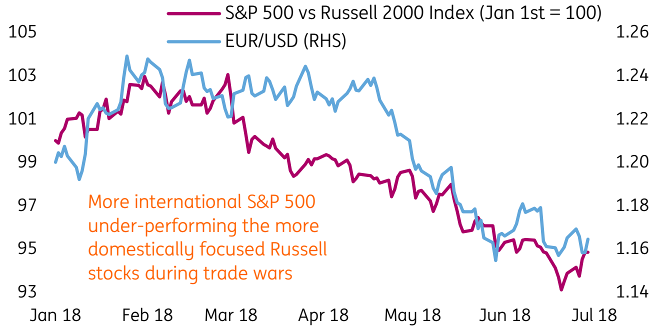
Alternatively a US inflation break-out prompting a faster Fed tightening cycle (two year swap spreads move to -350bp from -300bp currently) at a time of trade wars and the 30% equity decline scenario could put EUR/USD below parity.

Of course this matrix is not the last word on where EUR/USD will trade. As we've seen the risk premium can match and sometimes exceed the change in the fair value of the model. And the risk premium is not necessarily always EUR negative. Should the Trump administration, having seemingly abandoned G7, choose to talk the dollar down, we could start to see EUR/USD trading above FFV.

Equally portfolio flows surrounding QE have been notoriously difficult to model. However, the end of QE from the ECB and the return of long term debt flows into the Eurozone could again see EUR/USD trade above FFV. This is something the ECB felt explained the EUR/USD divergence from rate spreads last year.

EUR/USD scenario analysis: Assessing the four key significant inputs

Fig 3 EUR has underperformed as trade war risks mount



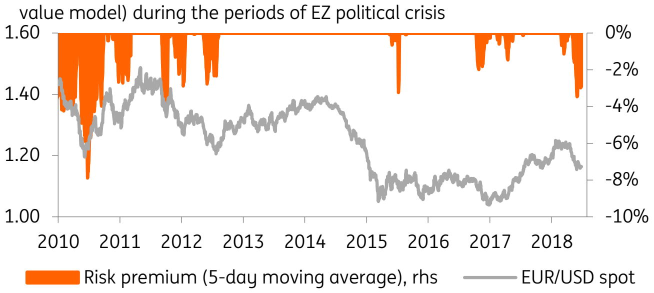
Source: ING, Bloomberg

Trade war scenarios

With the White House on a firm protectionist path, we stipulate two conditions for the global trade war to shift from a 'cold' to a 'hot' conflict: (1) **US tariffs broaden out to the auto sector** and (2) the **administration imposes a 20% blanket tariff on all Chinese imports**. This may be the most negative outcome for the EUR, where US growth somehow maintains its momentum and growth differentials continue to widen. However a marked escalation from here, where **all major trading blocs erect tariffs to protect domestic sectors**, would precipitate the next global recession and see the **Fed reversing its tightening path**.

Fig 4 European political risk premium worth up to 8%

The chart shows EUR risk premium (derived from EUR/USD financial fair value model) during the periods of EZ political crisis



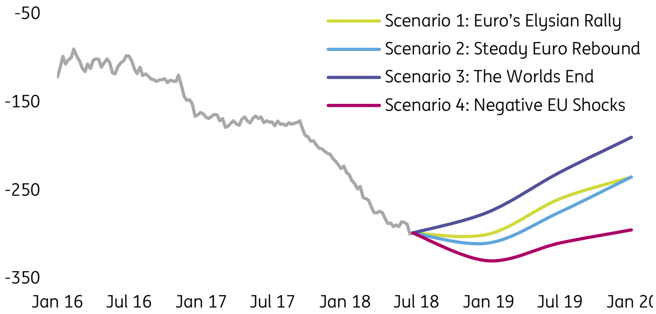
Source: ING

European political scenarios

European political risk has played a major role in EUR pricing – especially since the Greek crisis started to unfold in 2010. Our range of scenarios here start at the most positive, with a new-found push for reforms – or Macron momentum as our colleagues would say. Our baseline position would be more the muddle-through approach, the CSU coming back onside with Merkel and after some boundary-testing, **Italy staying onside**. The more bearish outcomes extend into **Salvini triggering new elections** in November and a worst case of a rudderless Europe and Italy fanning **fears of an EMU break-up** with their mini BoTs.

Fig 5 Further widening of EZ-US rate spreads hard to see

Eurozone-US 2Y swap rate differential (bps)



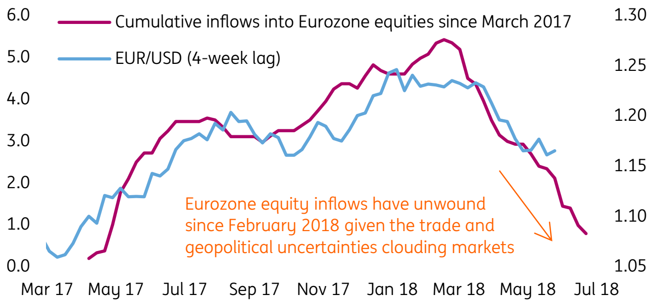
Source: ING Rates Strategy, Bloomberg

ECB versus Fed policy differential scenarios

Interest rate differentials did not have much of a say in EUR/USD last year, but have come back with a bang this year. The most positive scenario for EUR/USD here would probably see Eurozone growth bouncing back sharply in 2H18 and the market **questioning the credibility of ECB forward guidance** of no rate hikes until late summer. The most bearish scenario for EUR/USD would be one of **independent Eurozone pessimism**, driven by trade or politics, and a **Fed intent of further tightening**. A global recession prompted by protectionism may not be the most bearish for EUR/USD, since 2 year **USD rates could drop 150bp**.

Fig 6 Eurozone equity flows behind the EUR rise and fall

Cumulative flows into MSCI Eurozone Equity ETF since March 2017 (billions)



Source: ING, Bloomberg

Growth/equity differential scenarios

Having enjoyed the EZ re-rating story in 2017, the EUR has **suffered heavily from equity outflows in 2018**. Our most positive story would either see the EZ recovery return or the **fiscal drugs wear-off in the US** – favouring a re-weighting back to European equities. The most negative EUR/USD story would be a re-run of the EMU break-up story, **prompting capital flight** from EZ debt and equity markets. A global recession may not be the worst scenario for EUR/USD – despite the Euro's pro-cyclical credentials. The 2% p.a. offered by US T-Bills may not be enough to compensate for the **large US net foreign liability position**.

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