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

1. **Euro’s Elysian Rally**
   - Reduction in external risks (i.e., reduction in US-China trade tensions)
   - Italian politics stabilizes; ECB policies remain dovish
   - Eurozone growth prospects improve

2. **Steady Euro Rebound**
   - Tariff ceasefire (trade tensions ease)
   - Political stability in Europe (i.e., stable Italian government)
   - hawkish ECB

3. **The World’s End**
   - Dangling threats (i.e., US tariffs)
   - Slowdown in global trade (i.e., US-China trade war)
   - Trade tensions persist
   - Eurozone growth prospects decline

4. **Negative EU Shocks**
   - US protects cars
   - Hawkish Fed

**EUR/USD spot rate**

- End-2018 forecasts
- Scenario-based projections
- +/− 2 standard deviation implied volatility cone
- +/− 1 standard deviation implied volatility cone
- EUR/USD forward rate
- Scenario 1: Euro’s Elysian Rally
- Scenario 2: Steady Euro Rebound
- Scenario 3: The World’s End
- Scenario 4: Negative EU Shocks

**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.
Breaking down the drivers for EUR/USD

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.

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

**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.

**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 middle-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.

**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.

**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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**Fig 3** EUR has underperformed as trade war risks mount

![Graph showing EUR underperformance compared to S&P 500 and Russell 2000 Index](image)

**Fig 4** European political risk premium worth up to 8%

![Graph showing European political risk premium](image)

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

![Graph showing Eurozone-US 2Y swap rate differential](image)

**Fig 6** Eurozone equity flows behind the EUR rise and fall

![Graph showing cumulative equity flows into MSCI Eurozone Equity ETF](image)
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