Macro Comment

September 20, 2017

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Macro Research

EURUSD

A shift in tide for the EURUSD

The weak USD seen throughout the year will gradually feed into higher inflation, which in turn will lift interest rate expectations for the US and strengthen the USD.

At the Federal Reserve’s rate decision meeting on September 20, we expect the Federal Open Market Committee (FOMC) to announce the start of its balance sheet reduction.

EURUSD and US inflation turnaround

In mid-2016, inflation was approaching 2 percent, but the first half of 2017 has left the Fed and the market with one inflation disappointment after another (Figure 1).

![Figure 1: Core PCE and inflation surprise](image)

**Figure 1: Core PCE and inflation surprise**

Source: Macrobond, Bloomberg

Since the financial crisis, there has been a strong correlation between inflation and the exchange rate. Unsurprisingly, the Fed and the ECB have placed a high focus on lifting inflation, where both have alternately been helped by a weak currency. At the beginning of 2016, the annual change in the EURUSD peaked after two years of negative movements. This was accompanied by rising inflation in the eurozone. Currently, the annual change in the EURUSD rate has returned to the peaks from 2016. The recent exchange rate movements favour US inflation to rise relative to EMU inflation ahead (Figure 2).

![Figure 2: EURUSD and HICP annual change](image)

**Figure 2: EURUSD and HICP annual change**

Source: Macrobond, Bloomberg

EURUSD and interest rate expectations

After a closer look at the interest rate trends for the US and the eurozone, and their relationship with the EURUSD, we find that the response lag between interest rates and the EURUSD shifted around 2014-15. This period is characterised by two major events: 1) increased speculation about when the Fed would deliver its first interest rate increase after the asset purchase programme was finished; and, 2) preparations by the ECB to add to its stimulus of cutting interest rates by launching its asset purchase programme. From the start of the financial crisis to 2014-15, there was a clear one-year lag between the one-year curve slope (three years out) and the EURUSD rate (not shown). After 2014-15, the lag shortened to a quarter. This helps explain the EURUSD rate increase above 1.20 on September 8 (Figure 3).
Figure 3: EURUSD implicit forecast

Source: Macrobond, Bloomberg

Assuming that the relationship between the rate curve, inflation and the EURUSD continues to hold throughout the year, we forecast a lower EURUSD rate toward year-end, spurred by a gradual improvement in US inflation in general and compared to the eurozone specifically.

EURUSD and positioning

Our anticipated increase in US inflation (derived from the weaker dollar) would then feed into increased expectations of future increases in the US interest rate, which in turn will spur dollar bulls thereby closing the loop. Meanwhile, positioning in the EURUSD has climbed to its highest levels since the euro crisis. The number of traders who are net long the currency pair is at its highest since 2007 (Figure 4).

Figure 4: CFTC EURUSD positioning

Source: Macrobond, Bloomberg

Since the beginning of 2017, market players have pushed the EURUSD higher on the improved outlook for the eurozone and the uncertain outlook for the US. In our view, the continuing economic improvements, both in the eurozone generally and in Germany specifically, imply that politics will likely remain in check until early 2018. Toward year-end and early 2018, we believe political uncertainty is much more likely to affect the eurozone and the EUR in the months leading up to the Italian election. We expect this will contribute to a change in the tide among market players and their EURUSD view, if it does not happen before.

EURUSD and manufacturing sentiment

Alongside this, exchange rate movements imply slowing PMI numbers (next release on September 22) in the eurozone relative to the US (Figure 5). Heading into 2018, this makes it more difficult for the ECB and the eurozone in general. Deteriorating sentiment across the eurozone could prove particularly important in the period leading up to the Italian election and for dealing with the still-troubled banking sector in the eurozone.

Figure 5: PMI manufacturing implicit trajectory

Source: Macrobond, Bloomberg

Looking at inflation from an FX view

The relationship between the exchange rate and inflation is strong. Assuming that this relationship will continue to hold and assuming unchanged real effective exchange rates, we believe inflation in the US will rally whereas inflation in the EMU will remain muted. The relationship implies an increase to 3.5 percent in HICP terms for the US. In the eurozone, we think a drop toward 0.5 percent is more likely (not shown). Given the Q1 2018 consensus inflation outlook (mean/median), we argue that the US CPI is underestimated and the eurozone HICP is overestimated. A trend in line with this outlook would continue to support the strong relationship between inflation (in the US and the eurozone) and the EURUSD (Figure 6).
Conclusion

We believe it is likely that the EUR will remain strong the next one to two months, possibly extending its rally in the absolute short term, but weaken toward year-end. However, the weak USD seen throughout the year will gradually feed into higher inflation, which in turn will lift interest rate expectations for the US. Higher interest rate expectations and inflation rate will in turn gradually feed into a stronger USD.

By year-end 2017, heading into 2018, we believe that sentiment toward the US and the USD will have shifted, just as it will have done for the eurozone and the EUR. In our view, this will translate into a lower EURUSD toward year-end 2017, spilling over into 2018.

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