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ETF Securities FX Research:
Can the Euro sustain the 2017 rally?

Summary

- The Euro was by far the best performing G10 currency in 2017, returning 15% over the period. Although momentum is certainly favouring the Euro in 2018, and reaching a three-year high, the valuation appears stretched.
- Although European Central Bank (ECB) quantitative easing (QE) program appears at its limit, the central bank is concerned that the strong currency could impact its inflation forecasts.
- The Euro has been bolstered by demand from both bond and futures market buying. With positioning at extreme levels and it becoming more expensive to fund in Euros, we expect the rally is unlikely to last.

2017’s best performing currency

The Euro was by far the best performing G10 currency in 2017, returning 15% over the period. We expect that the Euro should end Q1 2018 under the 1.20 level, broadly in line with Bloomberg consensus estimates of 1.19. However, this displays the downside risk to the Euro remain elevated.

The Euro has benefitted from the improvement in the underlying economic environment, as well as recent comments by a handful of policymakers that there is the prospect of ending the ECB’s QE programme in 2018.

However, inflation expectations remain subdued in the Eurozone, and excess spare capacity in the labour market is likely to keep wage growth muted for some time. Eurozone inflation has declined after reaching the highest level in four years in early 2017 and is currently hovering around 1.4%, below the ‘close to or below’ the 2.0% ECB target.

Importantly, inflation is unlikely to spike above the central bank’s target in coming months, and the ECB will be concerned that the Euro is well above the level that its economic projections are predicated on : 1.18 against the USD. Indeed, as ECB Vice President Constancio recently stated that ‘I am concerned about sudden movements which don’t reflect changes in fundamentals’.

ECB nearing its limit

The ECB’s balance sheet has never been larger. However, the ECB is nearing the limit of its QE activities, with growth in its balance sheet fading.

Money supply growth has also been fading. However, the market seems to already be pricing in the possibility of monetary tightening in the Eurozone despite the ECB
having reduced its inflationary projection only in December because as ECB Vice President Constancio noted, ‘wages still aren’t growing sufficiently’.

Correspondingly, we feel that investors have been too quick to discount the potential for a build-up in inflationary pressure in the US and the corresponding need for the US Federal Reserve to implement its three forecast rate hikes in 2018.

**Demand for Euro funding**

The EUR/USD basis spread indicates that that real money demand for the Euro has risen to the highest level in around 18 months. Although the cross-currency basis shows hedging demand for Euros in the FX Swap market, this demand could dry up as it becomes more expensive to fund Euro loans.

**Euro appears to be mispriced**

Meanwhile, bond market pricing highlights that the currency bulls appear to getting ahead of themselves. EUR/USD appears out of line with where real interest rate differentials indicate the currency pair should be.

**What are markets pricing?**

Over the past year, optimism has engulfed the Euro: futures market positioning has rebounded from extremely depressed levels, to be currently at a record high. However, the Euro is more depressed than the historical relationship indicates. As a result, we expect that even a modest unwind of the stretched long positioning could prompt significant downside move for the Euro. Options market pricing is highlighting the Euro is expected to be the third best performer against the USD in the G10 in Q1 2018.

**Investor positioning**

Although the Euro should benefit if the ECB was able to cease its bond buying without any significant dislocations in interest rate markets by year-end, we feel the market has already priced in such a scenario.

We expect the Euro to weaken and move lower, under the 1.20 level in coming months, with further downside risks as H1 progresses.
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