Trade Idea – Foreign Exchange

Rate hike expectations resurface

3rd March 2016

Market expectations shift

• The EUR/USD currency pair has been subject to a great deal of volatility in 2016, despite only being up 0.1%* on a YTD basis. Earlier this month, the exchange rate reached a four month high of 1.133 before Mario Draghi’s dovish speech to the European parliament pulled the pair back down to the 1.08/1.09 range. The swings reflect market uncertainty around prospects for European and US economic growth and the future path of central bank policy. In the period leading up to and following the European Central Bank (ECB) and the US Federal Reserve (Fed) monetary policy meeting on the 10th and 15th March respectively, we believe the EUR/USD will come under pressure as investors re-establish expectations of US interest rate hikes and the ECB delivers on promises of further monetary easing.

Pressure on ECB to deliver

• The ECB’s current measures to ensure price stability appear to be inadequate. Eurozone inflation expectations are at the lowest level in over 12 years and advance inflation data released last Friday show that the Eurozone fell back into deflation in February (see Figure 1). The ECB is under considerable pressure to implement meaningful stimulus at its March meeting in order to restore price growth in the region. This is compounded by events in December, where ECB actions failed to meet market expectations and fuelled a 3%* EUR/USD appreciation. We expect Mario Draghi will follow through on recent rhetoric and implement further easing at the upcoming monetary policy meeting, likely in the form of larger monthly asset purchases and a further cut in the deposit rate. This should help pressure the Euro lower against its major currency counterparts, benefiting those with short exposure to the EUR/USD currency pair.

Figure 1

Further ECB rate cuts priced in.

Inflation metrics and expectations fall.

Source: Bloomberg, ETF Securities

*All figures quoted are sourced from Bloomberg unless stated otherwise.
Core US inflation approaches target

- In the wake of recent market turbulence, expectations of further US interest rate hikes in 2016 dropped to zero. However, the strength of recent US inflation readings, both headline and core, have prompted investors to revisit these expectations. The Fed’s favoured measure of inflation, personal consumption expenditure (PCE) core price index, rose to 1.7%* in January, over half a percent higher than consensus estimates. This puts the measure very close to the Fed’s target of 2% and at a level that the average Fed official didn’t expect to reach before Q4 of this year. The data dependent approach that the Fed claims to follow should mean that, contrary to market expectations, more rate hikes are on the way in 2016. As investors re-price this into short term market rates the US Dollar should receive support. We could therefore see the EUR/USD trending lower in the coming weeks.

- Commodities Futures Trading Commission (CFTC) data shows that since the start of December, short positioning to the EUR has unwound to the lowest level in 15 months, closely tracking reduced expectations of a Fed rate hike (see Figure 2). In coming weeks, as expectations of 2016 US interest rate hikes reassert themselves, we could see a corresponding build in short positions against the Euro, placing the EUR/USD under pressure.

Figure 2

![Chart showing US rate hike expectations to resurface.](chart.png)

Source: Bloomberg, ETF Securities

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