

The euro: higher or lower?

The euro's resurgence this year (8% higher against sterling and 12% higher against the US dollar) has come on the back of an improving growth backdrop together with receding political risks, following the market favourable election results in the Netherlands and France. So far, the upcoming German election in September does not look to be a market concerning event, whichever one of the two main parties wins a governing majority.

Contrast improving events in Europe with the UK, where economic momentum looks uncertain. Monthly factory orders this year suggest that the sector is failing to capitalise from a weaker sterling and a pick-up in global trade. In addition, political uncertainty is weighing on the UK currency. Despite the UK Government softening its Brexit 'red lines' on the role of the European Court of Justice, sterling continued to fall this week.

Contrasting economic fortunes will most likely mean divergences in monetary policy. Investors have been pricing in the prospect of a reduction of monthly asset purchases from the European Central Bank. At the same time, in response to flip-flopping comments from UK policymakers, investors have pushed out expectations of an imminent Bank of England interest rate increase until the first half of 2019.

The euro's fortunes this year are also at odds with those of the US dollar. Positioning in the US dollar reflects investors' pessimism about the ability of the Trump administration to make progress on its legislative agenda, particularly on tax reform. Meanwhile, the US treasury market remains sanguine on US monetary policy and does not appear to be pricing in more than one rate increase this year, contrary to current US Federal Reserve policymakers' forecasts.

Further euro strength is a concern for policymakers

For now, we expect euro strength to be sustained against sterling owing to improving economic fundamentals in Europe; a narrowing interest rate differential; and continuing Brexit uncertainty that is likely to weigh more heavily on the UK economy.

However, continuing euro appreciation versus the US dollar is more questionable. The strength of the euro is a concern for the European Central Bank, which is endeavouring to lift inflation to target. Furthermore, investor positioning is extended in the euro versus the US dollar and potentially at risk of being unwound. We also believe that investors are probably too optimistic on the outlook for Fed policy normalisation. While the euro seems to be the market's favourite for now, it is likely to see more mixed performance going forward – after having done so well.

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