Our View on Currencies

Edition October and November 2023

VP BANK

Different paths taken by central banks

After the unexpected sharp rise in inflation rates, central banks trust models less and give more weight to actual data. This also has an impact on currency markets.

The September meetings of the central banks were quite interesting. As expected, the Fed left its key interest rate band unchanged, but stuck to its hawkish tone and did not rule out another rate hike in November. The Swedish central bank (Riksbank) sounded a similar note. There, the key interest rate was raised as expected and the possibility of further interest rate hikes is being examined. The Riksbank was also surprisingly hawkish. On the other hand, both the Swiss National Bank (SNB) and the Bank of England made a splash: Both central banks left their key interest rates unchanged and want to continue to wait and see.

This, in turn, contrasts with the ECB's almost timetable-like behaviour: A further interest rate hike of 25 basis points was implemented. However, Frankfurt was cagey about the future course of monetary policy.

One thing became clear: the central banks are increasingly aligning their monetary policy with actual data after the inflation models failed to predict the strong increase we have witnessed. The foreign exchange markets are therefore acting cautiously. For the time being, no big bets are being made; after all, the central bank could still turn the interest rate screw further. And the question of all questions is still unanswered: Will there be a recession in the US or not? The uncertainty on currency markets is correspondingly great. The players probably feel most comfortable to waiting on the sidelines for now. In this edition of "Our View on Currencies", the sideways arrow therefore dominates the forecasts.

Dr. Thomas Gitzel**, Chief Economist**

Our View on Currencies - Overview

Currency pairs

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Our View on **EUR/USD**

1.05 – 1.12
Expected range
for 3 to 6 months

- ECB reached the interest rate peak
- Speculative net shorts on the euro have largely been unwound
- Monetary policy no longer supports the dollar

- Emerging financial market stress helps the dollar as a safe haven
- A weakening of the ECB's will in the fight against inflation could promote a renewed depreciation of the euro
- If the Fed were to continue raising rates for a longer period, the dollar could gain again

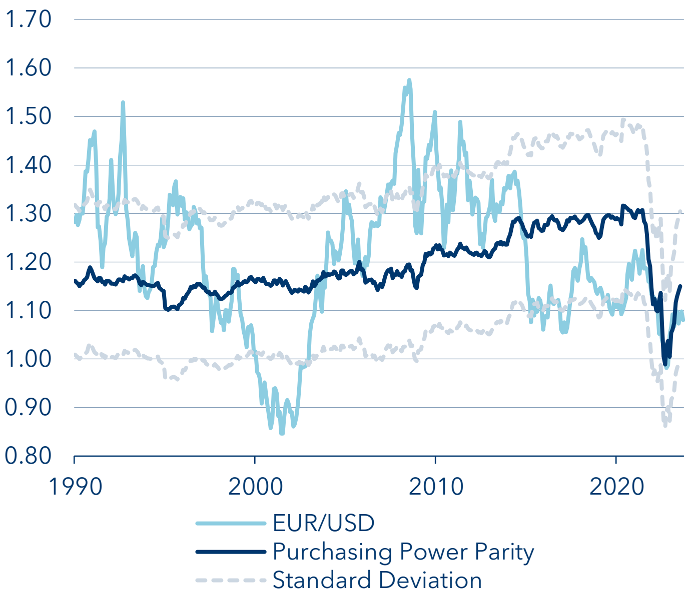
ECB has reached its interest rate high

The ECB probably launched its last rate hike in this cycle at its September policy meeting. The European monetary policymakers do not state this so clearly, but the coded choice of words suggests this interpretation. The economic risks do count more now. But it is by no means the case that interest rate cuts are on the agenda soon. The ECB's motto is "higher for a longer". This means that the potential for monetary policy surprises on the euro side has been exhausted. For this reason, we are adjusting our currency outlook and now expect a sideways movement of the EUR/USD currency pair between 1.05 and 1.12. From a market perspective, the high net shorts on the euro have now also been unwound. It was precisely these net shorts that served as a contra-indicator for a euro appreciation, which worked quite reliably. After all, the euro was still trading at levels of 0.95 against the dollar about a year ago.

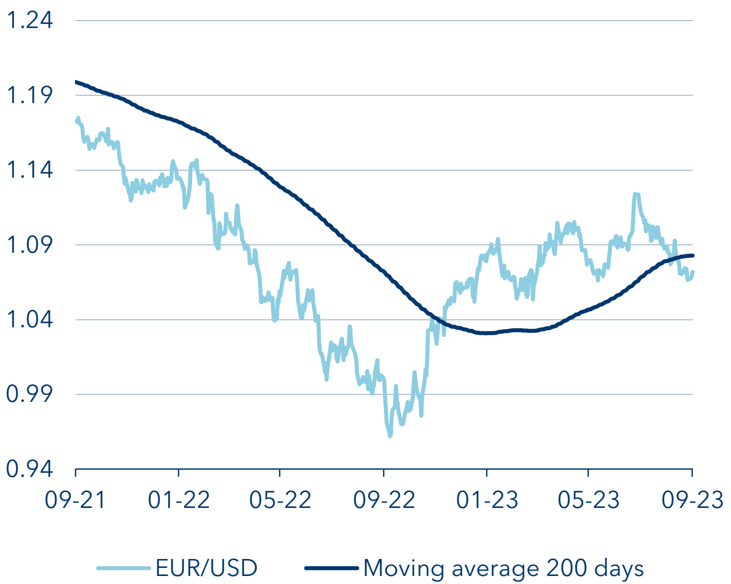
Our View on **EUR/USD**

1.05 – 1.12
Expected range
for 3 to 6 months

Purchasing power parity (producer prices; monthly data)



Technical view



Our View on **EUR/CHF**

0.95 – 1.00
Expected range
for 3 to 6 months

- Euro loses monetary policy support
- SNB could also reach interest rate peak
- The EUR/CHF currency pair is largely unaffected by monetary policy for the time being

- If the ECB falls short of market expectations, this could weigh on the euro in the coming months
- A sudden flight to safety would significantly weaken the euro against the franc

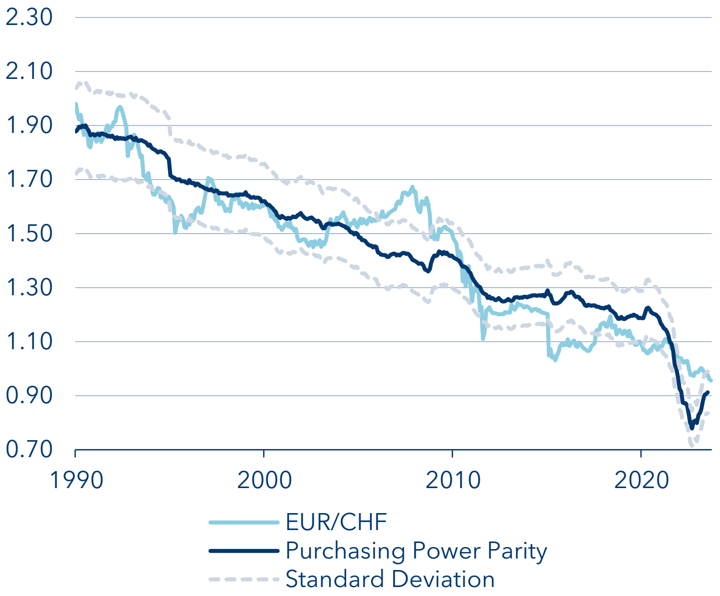
The SNB surprises

Surprisingly the Swiss National Bank, the SNB, moved to the sidelines and paused. According to the SNB, the significant tightening of monetary policy over the last few quarters is counteracting the inflationary pressure that still exists. Nevertheless, the Swiss policymakers do not rule out more monetary tightening. The franc depreciated somewhat following the SNB's surprise pause, but on balance it remained at firm levels. We do not expect the SNB's decision to have a lasting impact on the currency. Inflation rates in Switzerland have already reached comfortable levels below 2%. Also, the Swiss franc continues to be supported by the SNB. The balance sheet total of the Swiss central bank has been reduced by 30 percentage points in relation to GDP (from just over 140 % to just under 110 % of GDP). The large foreign currency holdings are thus being reduced. This means that the SNB is selling foreign currencies (i.e. euros) and thus supporting the franc.

Our View on **EUR/CHF**

0.95 – 1.00
Expected range
for 3 to 6 months

Purchasing power parity (producer prices; monthly data)



Technical view

Our View on **USD/CHF**

0.86 – 0.94
Expected range
for 3 to 6 months

- Both currencies are in demand in times of high uncertainty
- Dollar loses monetary policy tailwind as Fed reaches end of rate hike cycle in our view

- In the event of risk aversion in markets, the dollar would have an edge over the franc
- If the SNB were to prematurely declare its rate hikes over, this could weaken the CHF

Robust US economy helps the dollar

Recently, the dollar strengthened again globally. Above all, the US economy, which continues to run robustly, is likely to play a central role in this. The markets' calculation is as follows: if the US economy manages a soft landing despite the Fed's interest rate hikes, then the Fed would not make any significant interest rate cuts in the future. What is more, there would even be a risk of further interest rate hikes. This would give the dollar an interest rate advantage over a longer period of time. However, we still expect a recession, so that more significant interest rate cuts could also be on the agenda in the medium term. Precisely for this reason, the franc should basically remain at a firm level against the greenback. However, we are taking the recent strength of the dollar into account and are adjusting our target range slightly upwards to 0.86 - 0.94 (old: 0.84 - 0.90).

Our View on **USD/CHF**

0.86 – 0.94
Expected range
for 3 to 6 months

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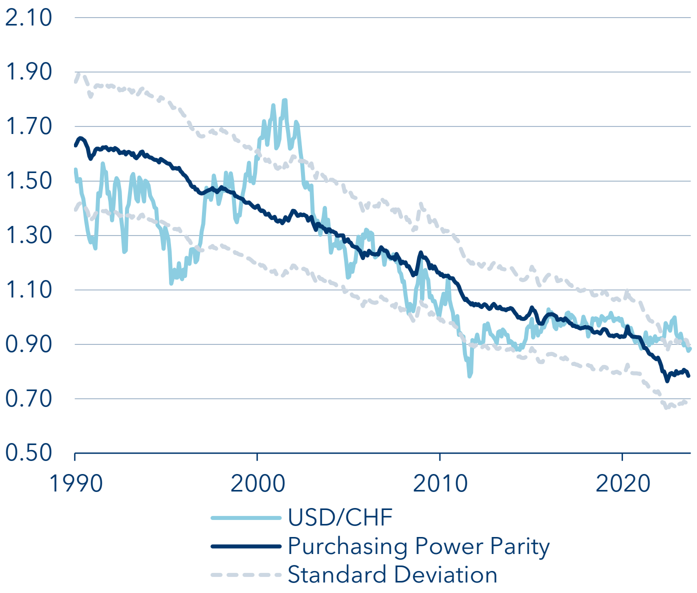
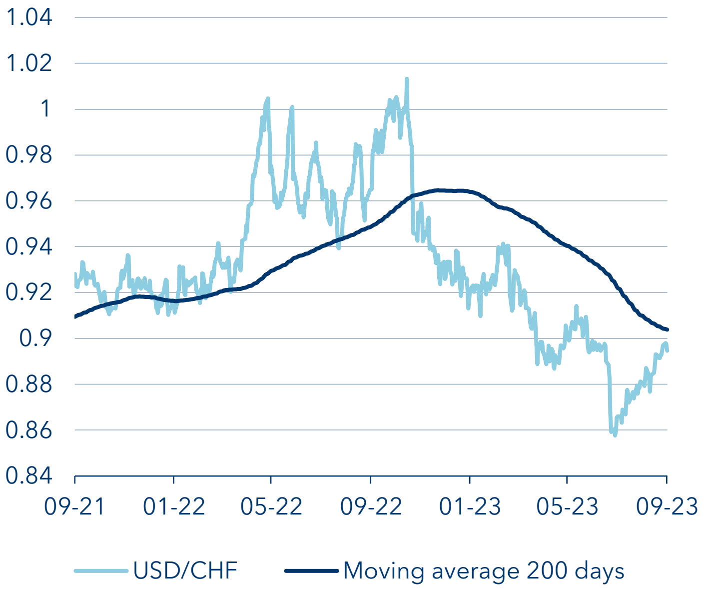


Technical view



Our View on **GBP/USD**

1.22 – 1.30
Expected range
for 3 to 6 months

- The pound is blatantly undervalued against the dollar
- On the dollar side, the Fed's rate hike path is complete

- Brexit reduces the UK's potential growth, which argues against a significant appreciation of the pound
- The pound remains fundamentally burdened due to a possible weaker economic development in the UK

Bank of England: No more interest rate hikes

The economy of the United Kingdom is showing signs of weakness. Even though a growth of 0.2 % was recorded in the second quarter, the danger of recession is great with a view to the second half of the year. For this very reason, the Bank of England (BoE) has recently refrained from further interest rate hikes. Contrary to expectations, the BoE kept the key interest rate at its September meeting unchanged. However, there is a danger of inflation consolidating at a high level. Rising wages in particular could contribute to this. In view of these risks, the Bank of England remains too much on the cautious side in its choice of words, i.e. there is no commitment to more monetary tightening in case of doubt. This has been a burden on the pound recently and, on the other hand, the dollar has been flexing its muscles globally. We are adjusting our forecast and now expect a sideways movement in the range between 1.22 and 1.30.

Our View on **GBP/USD**

1.22 – 1.30
Expected range
for 3 to 6 months

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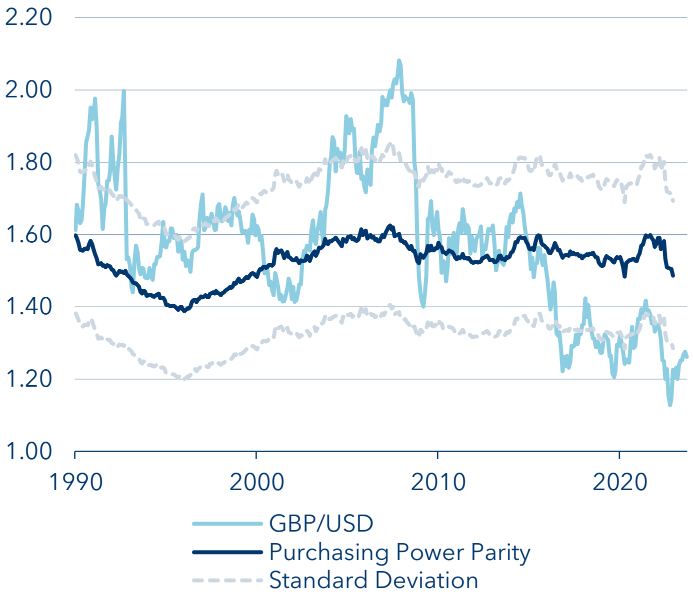


Technical view

Our View on **EUR/SEK**

10.80 – 11.50
Expected range
for 3 to 6 months

- High current account surplus and healthy public finances counter SEK weakness
- A weakening of the ECB's will in the fight against still high inflation would weaken the euro

- Currently still unfavourable environment for high-beta currencies like the SEK
- The Swedish central bank sounds increasingly cautious about further interest rate hikes in view of still high inflation, which could further weaken the SEK

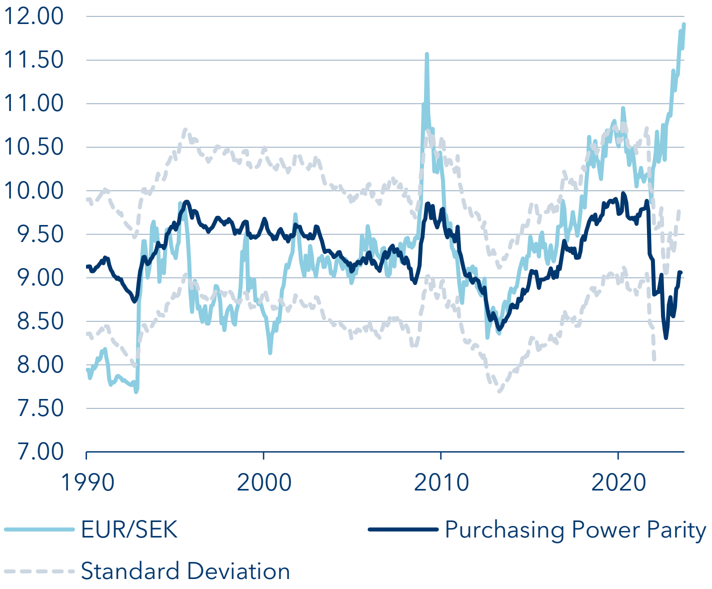
Krona cannot benefit from undervaluation

The Swedish central bank (Riksbank) raised the key interest rate by 25 basis points to 4% in September, as expected. The Riksbank reserves the right to further rate hikes. This could provide some monetary tailwind for the Swedish krona in the coming months, as the ECB seems to have reached its interest rate peak. Meanwhile, the Swedish krona has depreciated further against the euro in recent weeks and recently traded just below 12. Since the Riksbank could turn the interest rate screw even more, there is a certain degree of appreciation potential from a monetary policy perspective. This is also reflected in our unchanged forecast range, which now implies an appreciation of the krona. However, a fundamental change is needed for sustained appreciation. Only in the event of a global economic upswing will the SEK be able to appreciate over a longer period. Levels below 10 of the EUR/SEK currency pair will not be on the agenda for the foreseeable future.

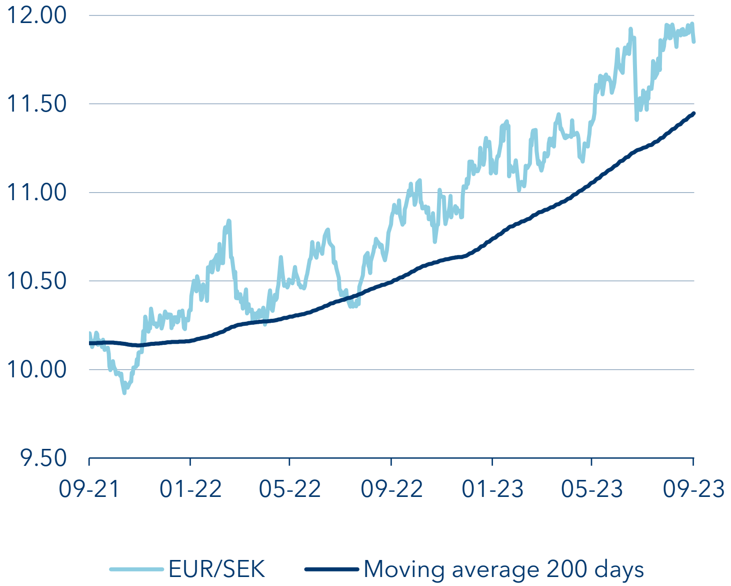
Our View on **EUR/SEK**

10.80 – 11.50
Expected range
for 3 to 6 months

Purchasing power parity (producer prices; monthly data)



Technical view



Authors and Disclaimer

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On Purchasing Power Parity: The Purchasing Power Parity (PPP) describes that a product costs the same in two countries as long as it can be traded without restrictions and the transaction costs are negligible. The relative PPP used here is based on producer price indices and assumes that the prices of the products change by the same amount, taking into account the exchange rate, but that the price levels may differ.

Source: Bloomberg

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