Our View on Currencies

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VP BANK

The Bank of Japan did it

Monetary policy has at last moved the currency markets. But by and large, the overall sideways trend prevailed.

After a long lull, the currency markets came back to life. The Swiss National Bank (SNB) surprised with an interest rate cut. This led to a depreciation of the Swiss franc, although this was limited.

Meanwhile, the yen was unable to benefit from the interest rate hike by the Bank of Japan (BoJ). The BoJ raised its key interest rate for the first time in 17 years. The fact that Japan's monetary policy has become more restrictive is seen as historic, even though the move was tiny. The BoJ raised the key interest rate from –0.1% to a range between 0% and 0.1%.

But the yen has not increased in value because the Japanese central bank will maintain its current bond purchasing volumes. It will merely refrain from explicitly steering the yield curve. Thus, monetary policy has, in fact, changed very little. Markets therefore saw no reason for the yen to appreciate. In terms of purchasing power parity, the Japanese currency is heavily undervalued against the dollar by almost 40%.

An appreciation of the yen would be positive, but currency traders are currently focused on more than just symbolic monetary policy decisions. A further tightening of the policy is necessary for the yen to gain strength.

Japan's interest rate disadvantage compared to the US or the eurozone has hardly changed as a result of the BoJ's latest decision. It will probably take bigger interest rate cuts by the Fed and the European Central Bank (ECB) for the yen to gain somewhat against the dollar or the euro. However, this would not be an explicit strengthening of the yen but a weakening of the dollar or euro.

Dr. Thomas Gitzel, **Chief Economist**

Our View on Currencies - Overview

Currency pairs

- **EUR/USD – Page 4**
  Expected range 1.06 to 1.14
- **EUR/CHF – Page 6**
  Expected range 0.95 to 1.00
- **USD/CHF – Page 8**
  Expected range 0.86 to 0.94
- **GBP/USD – Page 10**
  Expected range 1.22 to 1.30
- **EUR/SEK – Page 12**
  Expected range 10.80 to 11.80

Our View on **EUR/USD**

1.06 – 1.14
Expected range
for 3 to 6 months

- ECB and Fed have set their sights on interest rate cuts
- Residual inflation risks exist on both sides of the Atlantic, there will be no rapid cut of interest rates
- Dollar remains in demand as a safe haven in uncertain times

- More extensive interest rate cuts by the ECB than previously expected could significantly weaken the euro
- Financial markets are expecting a soft landing for the US economy; a hard landing could weaken the dollar significantly

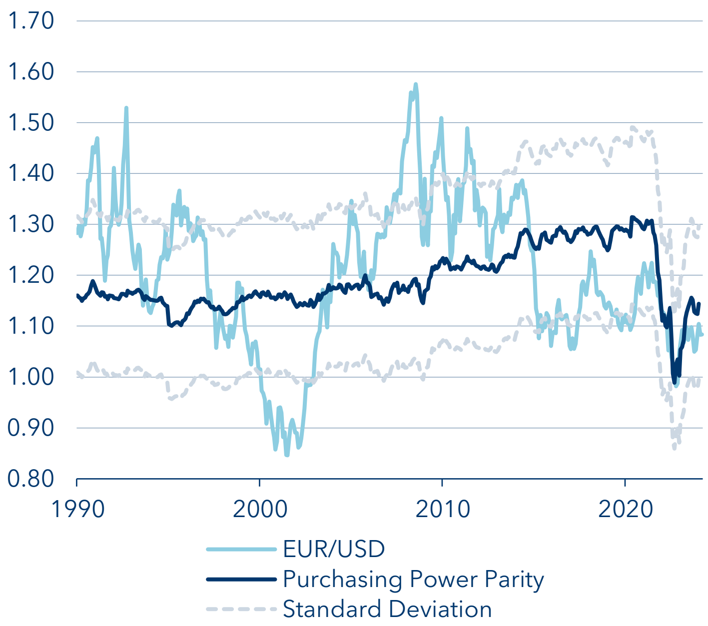
Stalemate

The decline in US inflation is proving to be sluggish. So there is currently no need for the Fed to cut the key interest rate quickly. At first glance, the slight depreciation of the dollar against the euro may not seem to fit with this news. However, on the euro side, the decline in inflation has also stalled somewhat recently. There will be no ECB interest rate cuts soon - as early as April, for example. So there was a stalemate from a monetary policy perspective. However, the euro had a slight advantage because the currency markets were secretly expecting more early monetary easing from the ECB. In the short term, the dollar could strengthen again, especially if expectations of a rate cut by the Fed have to be put off further. However, this will not change the overall sideways movement. For this reason, we see no need to adjust our forecast range.

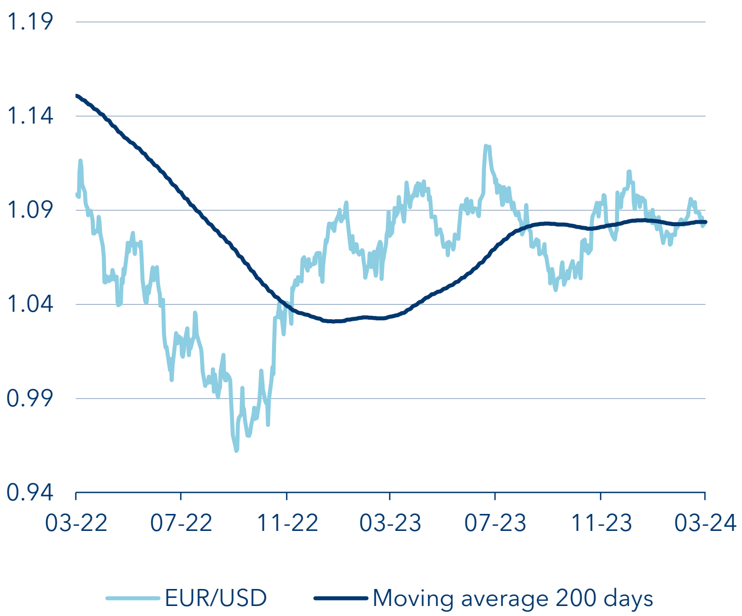
Our View on **EUR/USD**

1.06 – 1.14
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

- The ECB will launch its first interest rate cut in the middle of the year
- Purchasing power parity speaks in favour of a stronger franc
- Technically, a moderate appreciation of the franc after the recent devaluation seems on the cards

- The SNB surprised with an interest rate cut. More easing is likely to follow
- A sudden flight to safety would weaken the euro against the franc

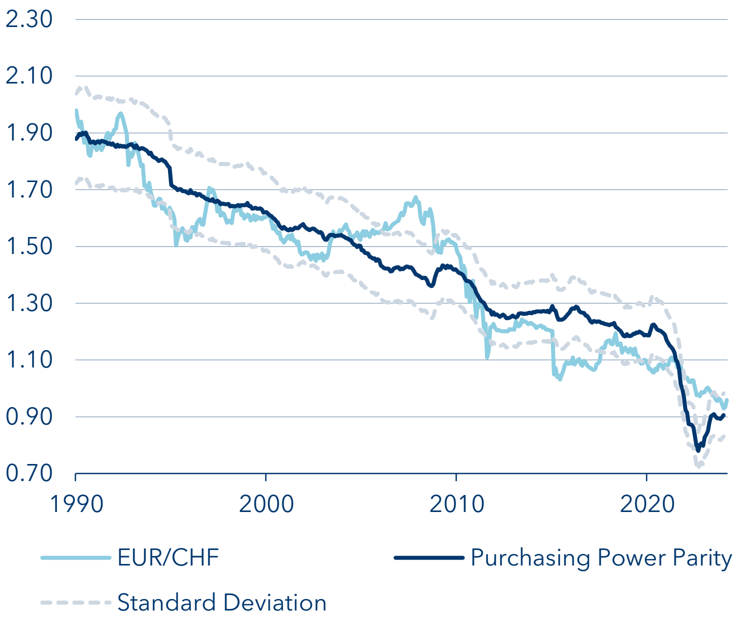
The SNB takes us by surprise

In March, the Swiss monetary policymakers unexpectedly lowered the key interest rate by 25 basis points to 1.5%. Most economists, including ourselves, had not anticipated a change. The franc depreciated immediately after the announcement, but exchange rate losses were limited. It is likely that further rate cuts will follow. Central banks typically reduce the key interest rate several times, not just once. Two additional cuts of 25 basis points each may be decided this year. Currently, 1% is probably the lower limit. The ECB will likely begin reducing interest rates in June, resulting in more reductions than on the Swiss side. As a result, the EUR/CHF exchange rate pair is unlikely to change significantly at first. We have slightly adjusted our forecast range but we do not anticipate any significant price fluctuations in the near future.

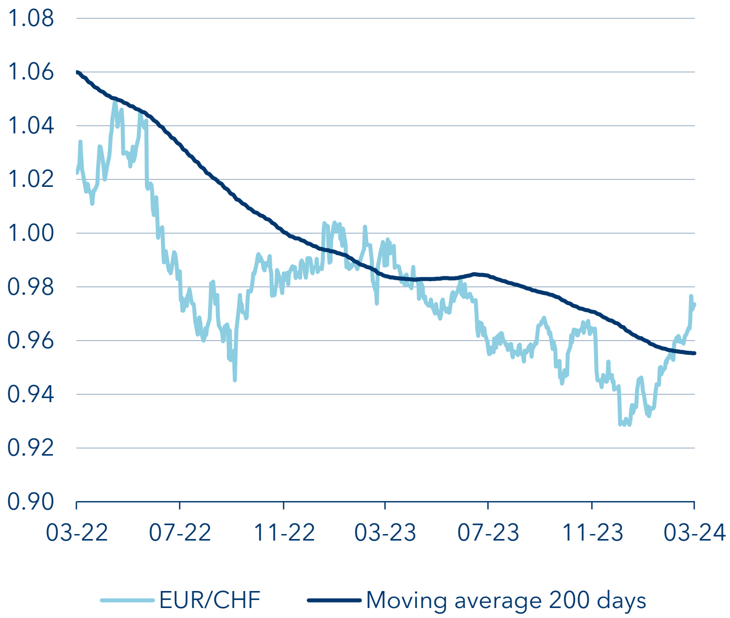
Our View on **EUR/CHF**

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
- If the US economy remains robust and inflation rates do not fall any further, the dollar would have a clear advantage

- If the US economy were to fall into recession after all, the Fed could cut interest rates more sharply than previously expected and the dollar would come under pressure
- Purchasing power parity speaks in favour of a significantly stronger franc

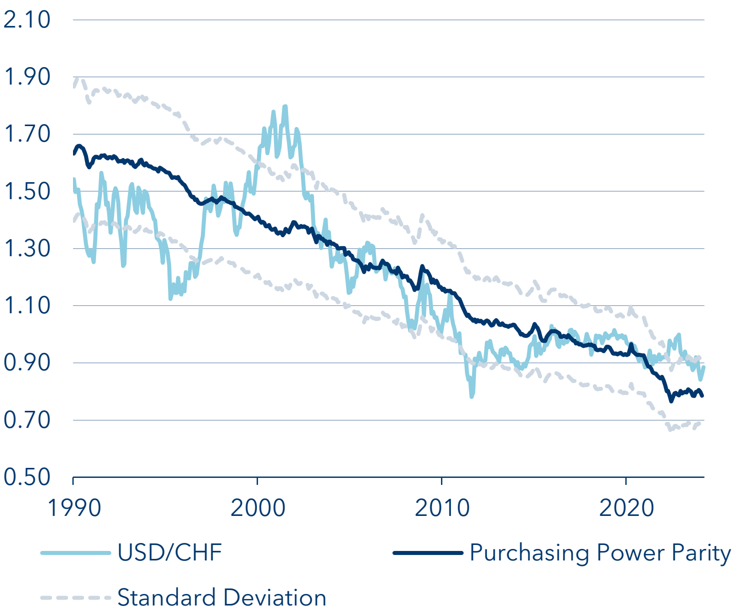
Rate cut expectations weigh on USD

The franc's recent weakness against the two main currencies reflects both the SNB's surprising interest rate cut and the significant appreciation at the end of 2023. The chart (see next page) shows that the deviation from the 200-day line was too large, indicating a probable correction. The dollar's future will depend on economic developments and the associated inflation trend. If the US economy proves to be stronger than expected, the Fed may delay or even cancel interest rate cuts for the time being. This could increase the value of the dollar. As this scenario is plausible, the dollar may outperform the franc for now.

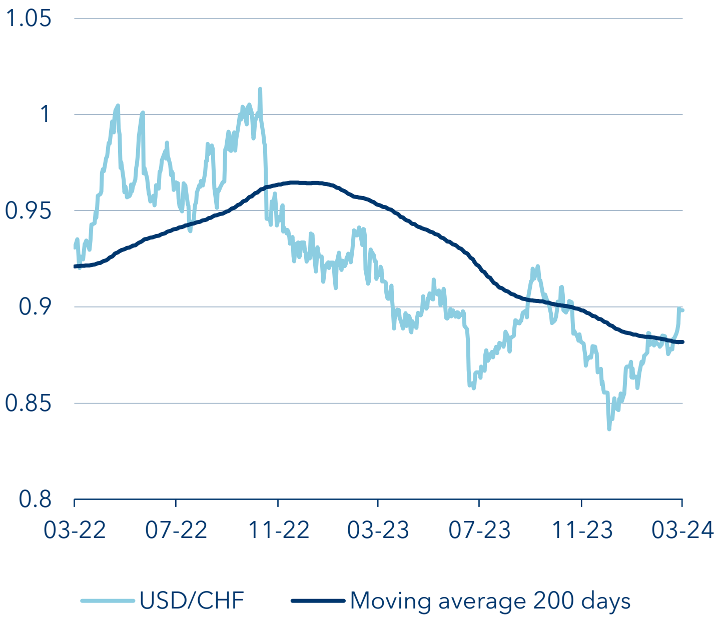
Our View on **USD/CHF**

0.86 - 0.94
Expected range
for 3 to 6 months

Purchasing power parity (producer prices; monthly data)



Technical view



Our View on **GBP/USD**

1.22 – 1.30
Expected range
for 3 to 6 months

- The Pound is clearly undervalued against the dollar
- The dollar is weakened by rate cut expectations

- Brexit is reducing the UK's potential growth, which prevents a significant appreciation of pound
- GBP remains fundamentally under pressure due to a weaker economic development in the UK

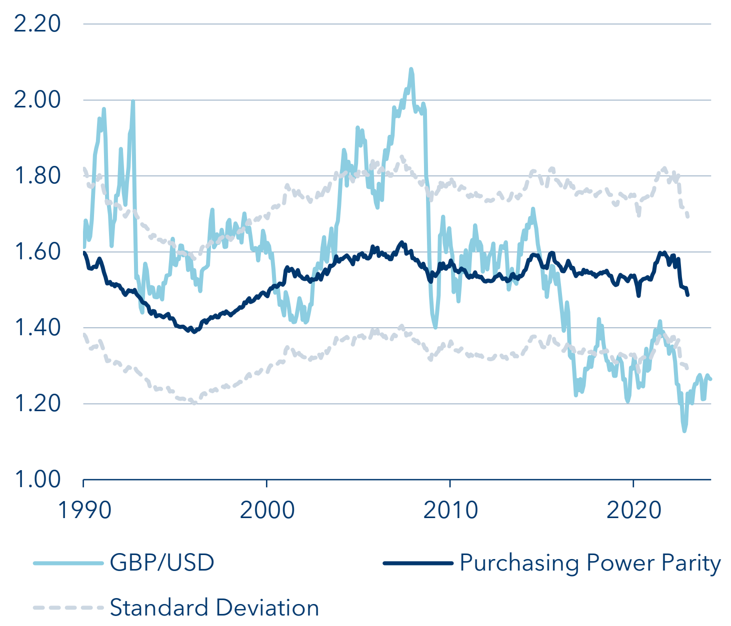
Structural factors weigh on the pound

The pound has been trading in a narrow range against the dollar for almost five months due to structural factors. The currency markets have been hesitant to take a clear position, and this is expected to continue. The US economy's continued robust development makes bets on interest rate cuts in the near future appear uncertain. Meanwhile, the situation in the UK remains challenging. Brexit is having a negative impact on the economy, while inflation remains unacceptably high. Excluding volatile energy and food prices, inflation recently stood at 4.5%. The pound lacks a fundamental basis for appreciation. From a purchasing power parity perspective, the pound is heavily undervalued, as illustrated in the chart (see left-hand chart on the following page). This aspect is likely not being considered in the currency markets.

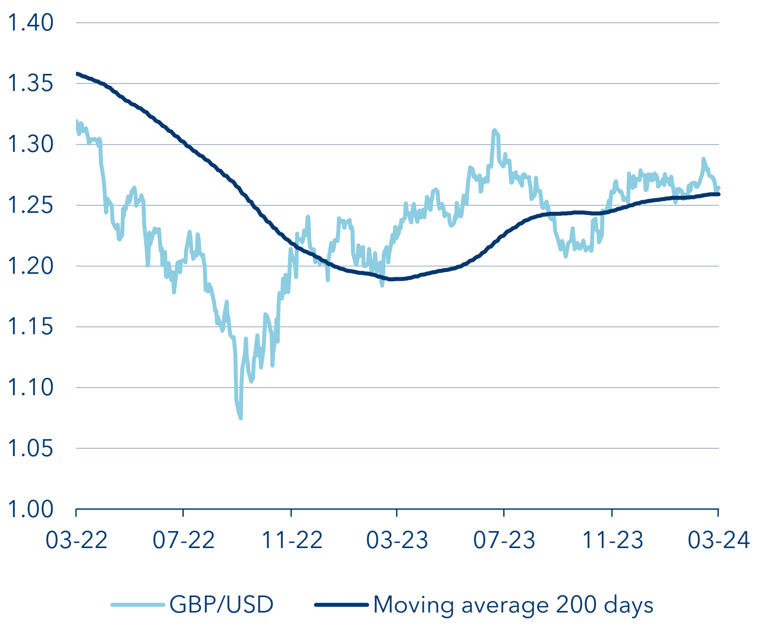
Our View on **GBP/USD**

1.22 – 1.30
Expected range
for 3 to 6 months

Purchasing power parity (producer prices; monthly data)



Technical view



Our View on **EUR/SEK**

10.80 – 11.80
Expected range
for 3 to 6 months

- A high current account surplus and healthy public finances counteract the weakness of the SEK
- A weakening of the ECB's resolve to fight the still high inflation would weaken the euro

- Continued unfavourable environment for high-beta currencies like the SEK
- Despite the inflation still being high, the Swedish central bank sounds increasingly cautious about further rate hikes, which could further weaken the SEK

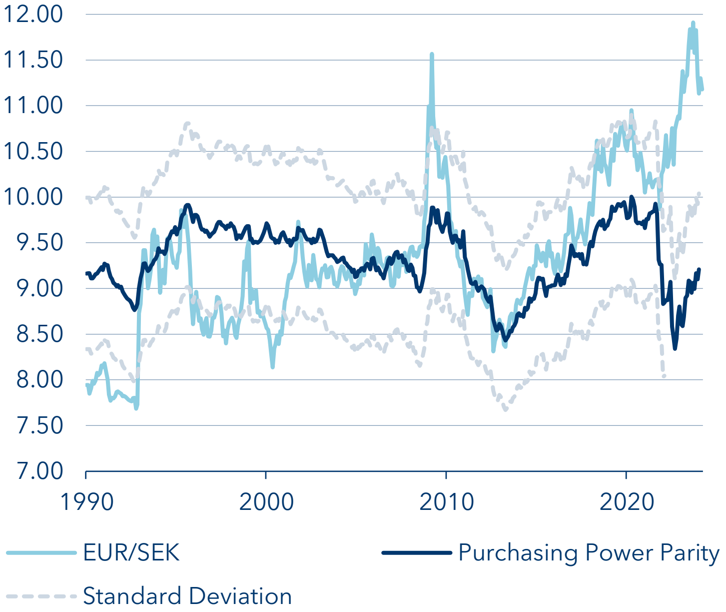
No trend reversal in sight

The weak phase of the Swedish krona continues, despite being blatantly undervalued in terms of purchasing power parity (see right-hand chart on the following page). Sustained gains in the krona are unlikely in the current environment. The SEK is a high-beta currency that benefits in an environment of global economic recovery. The SEK has been affected by the high level of geopolitical uncertainty surrounding the war in Ukraine and a weak economic environment. These negative factors are not expected to change soon, so the krona is likely to remain weak for some time. Although inflation rates are still relatively high at over 4%, they are on a downward trend. The Swedish central bank can no longer be accused of taking inflation risks too lightly.

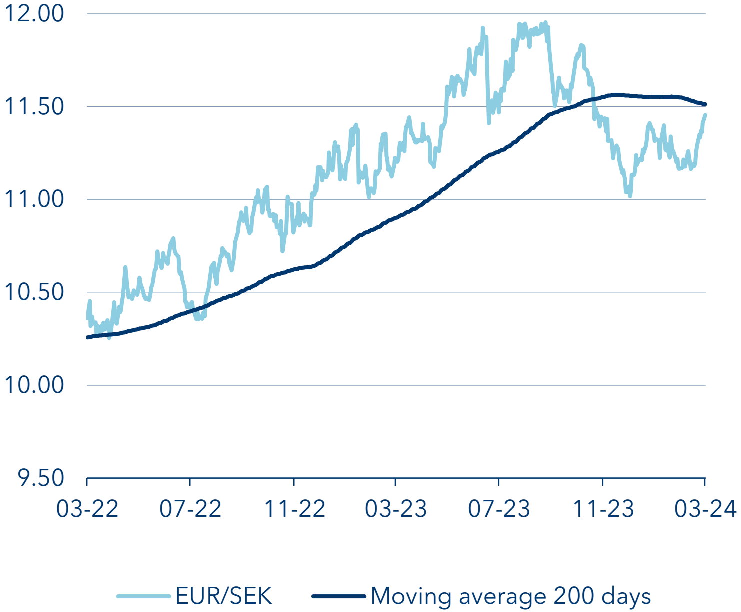
Our View on **EUR/SEK**

10.80 – 11.80
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