Our View on Currencies

Edition August and September 2024

VP BANK

Central banks: Now in step

The Fed is waiting

Probably sooner? There is talk of a possible interest rate cut by the US Federal Reserve (Fed) as early as September. After analysts' estimates of possible rate cuts over the course of the year outweighed each other at the end of 2023, the opposite was true shortly afterwards. Hardly any rate cuts were expected for 2024 as a whole.

Now the tide has turned. Fed Chairman Jerome Powell sees weakness in the labour market, and the Fed also believes that inflation rates are now moving in the right direction - down. Short-term futures contracts are now pricing in a full rate cut in September. This move is indeed expected as Fed officials have not contradicted these expectations.

It would put the Fed and the European Central Bank (ECB) back in lockstep. The ECB already cut its key rate in June and is likely to ease further in September and December.

The Swiss National Bank (SNB) has already cut interest rates twice by 25 basis points and is likely to tighten again in September or December.

What does that mean for currency markets? Probably not much, as the interest rate differential between the US and Europe will not change significantly. Joe Biden's decision not to run for the US presidency and the possible entry of Kamala Harris have not caused any major distortions in the currency markets. Although the dollar may weaken somewhat as interest rate cuts loom, significant losses are not expected.

Dr. Thomas Gitzel, **Chief Economist**

Our View on Currencies - Overview

Currency pairs

Our View on **EUR/USD**

1.06 – 1.12
Expected range
for 3 to 6 months

- Fed has its sights set on interest rate cuts
- Residual inflation risks exist on both sides of the Atlantic
- 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
- The financial markets are expecting a soft landing for the US economy; a hard landing could send the dollar into a tailspin

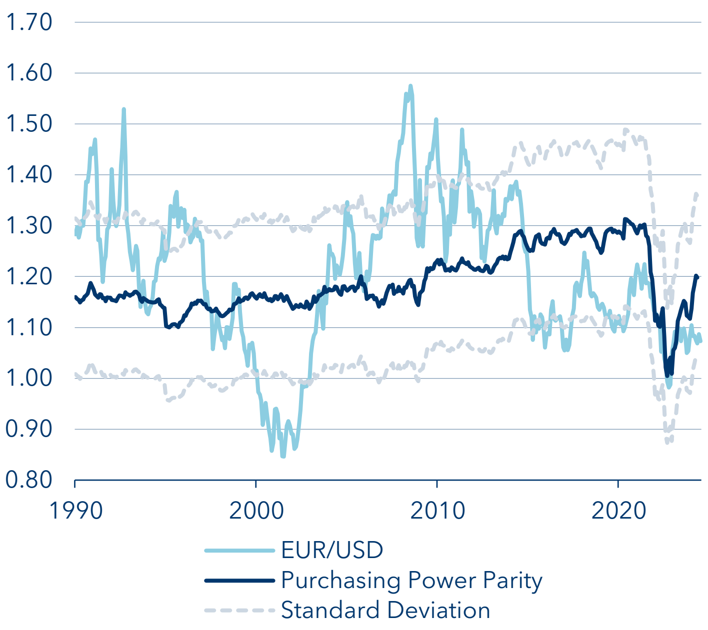
Dollar reacts to expectations of rate cuts

Joe Biden has decided not to run for president again. The announcement caused a political uproar but left the currency markets relatively unimpressed. The focus was on the fact that the Federal Reserve sees a deterioration in the US labour market. The unemployment rate stands at 4.1%, compared to a low of 3.4% in January 2023. At the same time, US inflation is falling, albeit slowly. Taken together, this is likely to lead to a rate cut in September. In any case, financial markets are relatively safe. Unless Fed officials contradict these expectations in their speeches, there will be a rate cut. Looking ahead, the start of the easing cycle could lead to a moderate weakening of the dollar. We do not expect the dollar to depreciate significantly. We currently see the euro's upper limit against the dollar at 1.12.

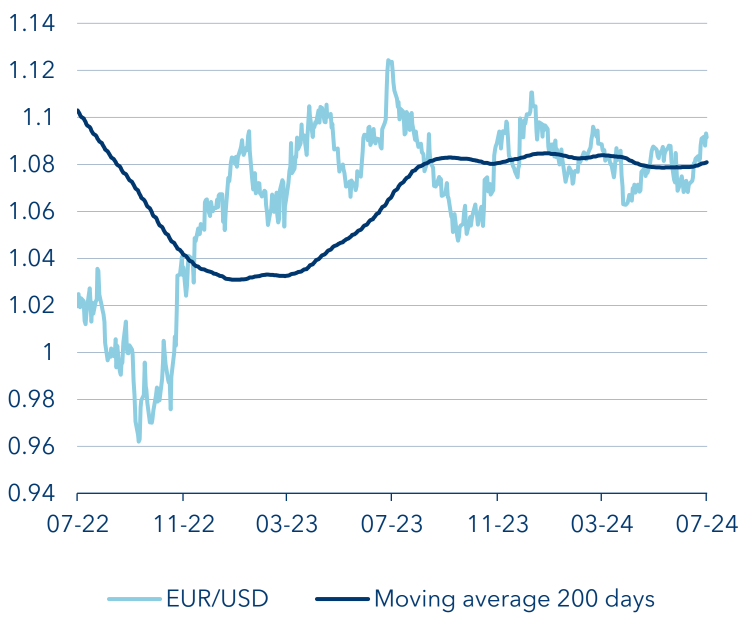
Our View on **EUR/USD**

1.06 – 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

- The SNB is one rate cut ahead of the ECB
- Purchasing power parity argues for a stronger franc
- The market technique shows a predominantly neutral picture

- There is no potential for significant SNB rate cuts
- A sudden flight to safety would weaken the euro against the franc

SNB cuts key rate again

In June, the SNB cut interest rates for the second time in a row. The repeated easing of monetary policy has not led to a significant weakening of the Swiss franc. This already shows that the franc is not about interest rates, but about other aspects. This includes its function as a safe haven currency. The uncertain political situation in France and the associated risks for the currency area make the franc a sought-after currency despite low interest rates. In addition, lower inflation than in other currency areas means a relative improvement in purchasing power in favour of Switzerland. Low inflation and low interest rates therefore lead to a strong rather than a weak currency. This has already been observed in the past. We therefore expect the Swiss franc to remain in a trading range between 0.95 and 1.00 against the euro for the time being.

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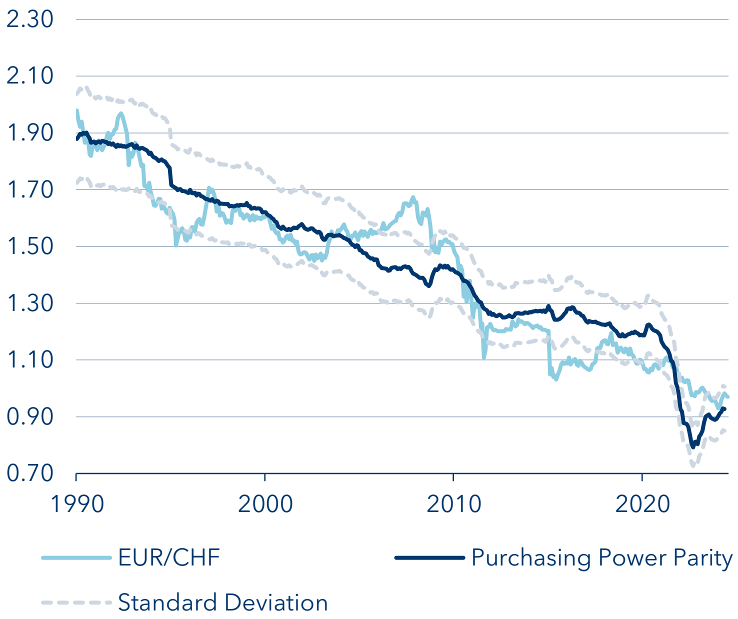

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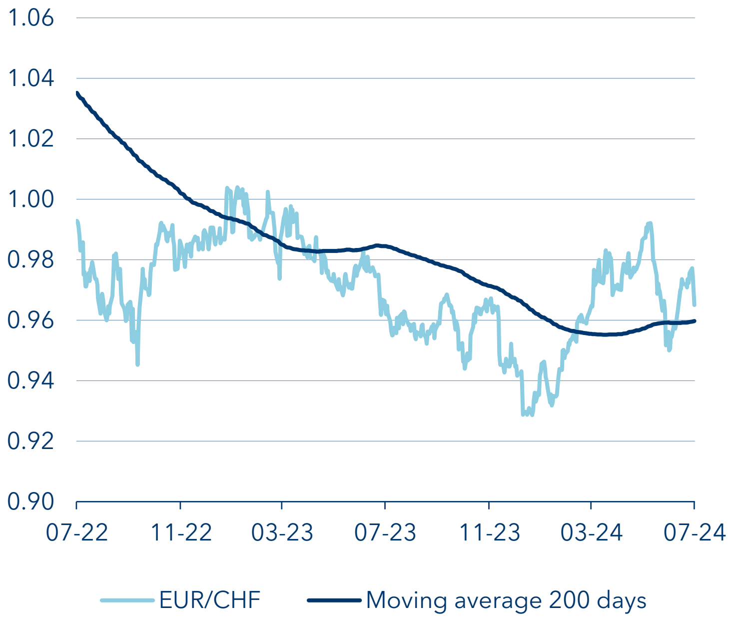

Our View on **USD/CHF**

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

The dollar and monetary policy

The Fed is a data dependent central bank after its inflation models failed to predict the sharp rise in inflation rates. Currency markets are therefore cautious. No big bets are being made for the time being. The recession we have been expecting is still a way off. Forex players are probably most comfortable in the sideways trading range at the moment, which is why no major moves are expected in the USD/CHF pair. What is new, however, is that expectations for a rate cut have shifted slightly forward again. Short-term futures markets are now pricing in a first rate cut by the Fed in September. This has recently led to a moderate weakening of the dollar. However, we do not expect a sustained and significant depreciation of the dollar.

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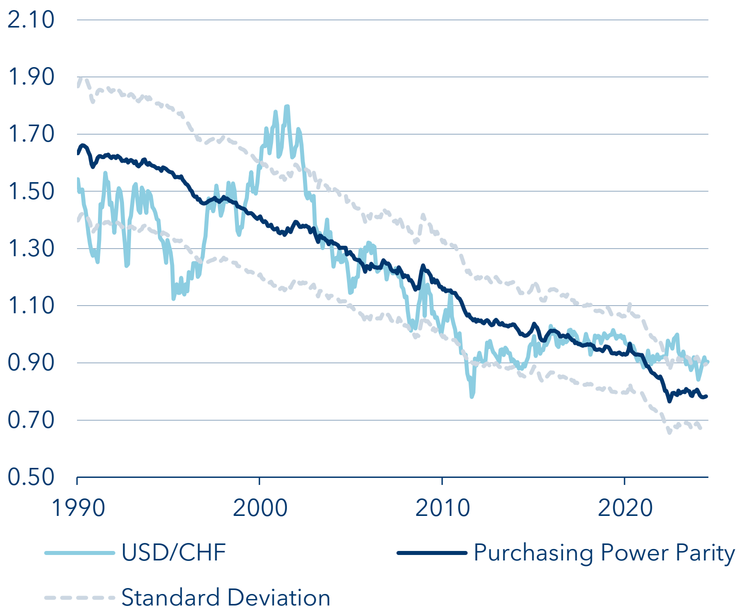

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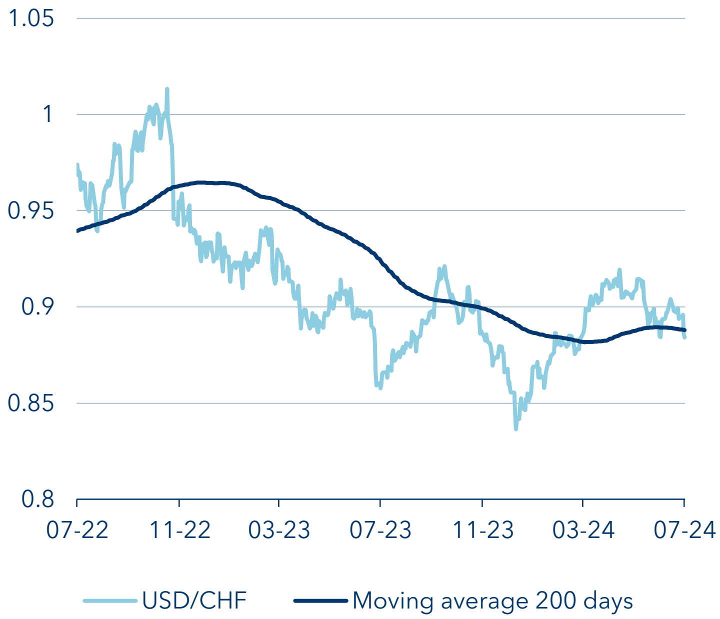

Our View on **GBP/USD**

1.26 – 1.34
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 weighing on sterling

In the UK, economic leading indicators suggest that the UK economy is on a moderate recovery path. First-quarter growth surprised on the upside, rising 0.7% quarter-on-quarter. However, the stance of the Bank of England, which is flirting with interest rate cuts despite the better than expected economic development and relatively high inflation rates, is not entirely in line with the improving economic data. An overly dovish Bank of England would also weigh on the Pound. For these reasons, we do not expect the Pound to strengthen significantly. However, a test of the 1.30 level could be imminent, and prices above this level are also conceivable. However, we do not see any appreciation beyond 1.34. Instead, short-term setbacks could be on the agenda again.

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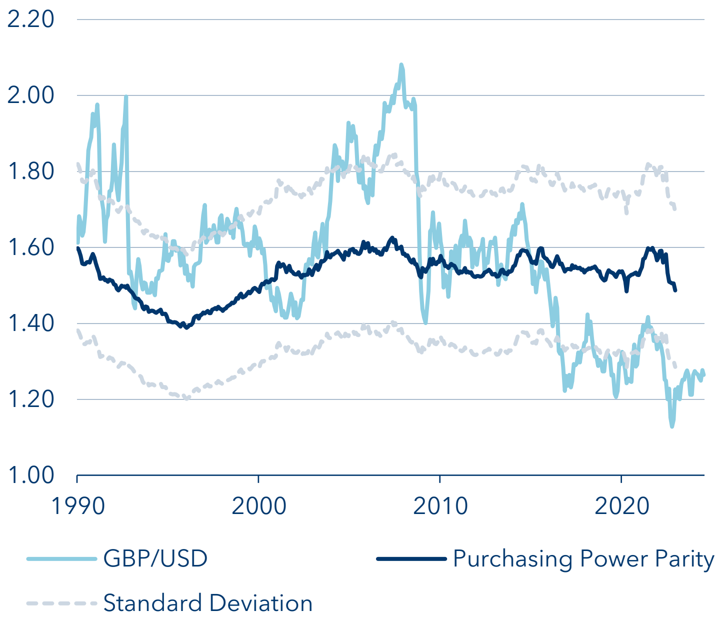

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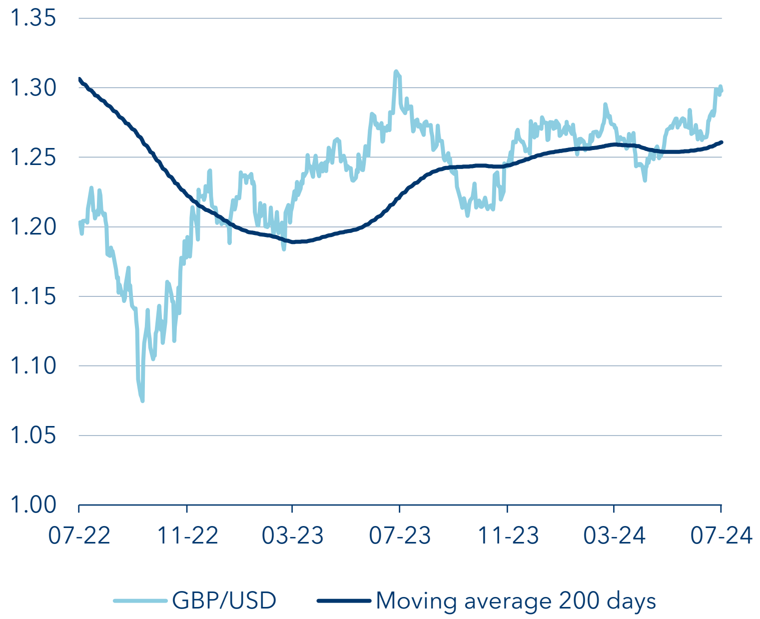

Our View on **EUR/SEK**

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 combat the still high inflation would weaken the euro

- Currently still unfavorable environment for high-beta currencies such as the SEK
- Swedish central bank sees more room for rate cuts this year

No quick turnaround in sight

The Swedish central bank (Riksbank) kept its key interest rate unchanged in June, following the rate cut in May. What was new, however, was the outlook on three rate cuts this year instead of two. While the Fed and the ECB are acting more cautiously than assumed at the end of 2023, the Riksbank is going in the opposite direction. It wants to cut interest rates more sharply. This, in turn, has not benefited the Swedish krona, which, after an initial appreciation, depreciated again against the euro by mid-June. This behaviour once again confirms our assessment that it will be difficult for the krona to break out of the trading range between 11 and 11.80 that has existed for some time. Despite the clear undervaluation of the krona against the euro in terms of purchasing power parity, we will probably have to wait a long time for an appreciation.

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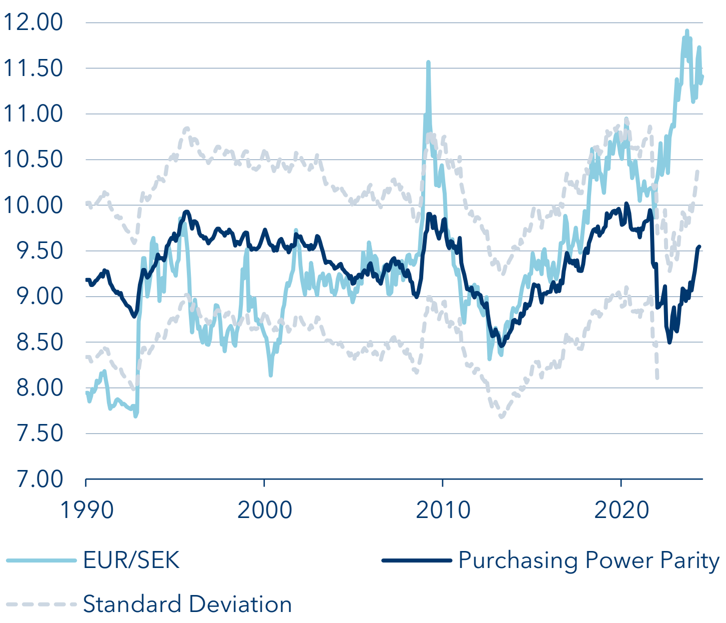

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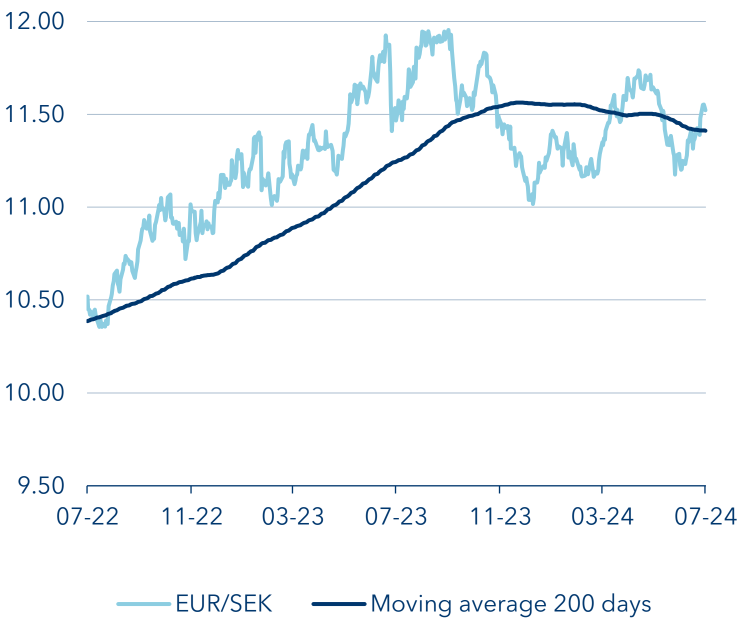

Authors and Disclaimer

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Dr. Thomas Gitzel, Chief Economist

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