Our View on Currencies

Edition June and July 2024

The paths of monetary policy on both sides of the Atlantic are diverging

The Fed is turning away from rapid interest rate cuts, but the dollar is not benefiting.

ECB and Fed monetary policies go their separate ways. Inflation rates continued to fall in the monetary union. Even excluding volatile energy and food prices (core rate), the inflation level of 2.5 % is within striking distance of the ECB's target of 2 %. As the ECB deposit rate is also at 4 % and the main refinancing rate at 4.75 %, there is scope for the European monetary authorities to cut interest rates. The situation in the USA is different: inflation rates there do not want to fall below the 3 % mark. At the same time - and in contrast to the eurozone - the economy on the other side of the Atlantic remains very robust. This means that there is no need for the US Federal Reserve to loosen monetary policy. However, anyone who thought that the widening interest rate differential between Europe and the US would lead to an appreciation of the dollar has been wrong so far. The foreign exchange markets do not believe that the US economy will survive a "higher for longer", i.e. a prolonged phase of high interest rates, without major wounds. The calculation is that the ECB would simply get ahead of the Fed and the US central bankers might have to cut interest rates all the more sharply at a later date. This scenario is certainly realistic. However, there is still a great deal of uncertainty as to whether this will actually happen. The fact is that the inflation trend over the past three years has been marked by numerous surprises - both upwards and downwards. This will also be the case in the coming months. However, as long as the inflation trend is associated with uncertainty, monetary policy will be too. And it is precisely for this reason that high "bets" on the currency markets are likely to remain cautious for the time being, which suggests that the most important currency pairs will continue to move sideways.

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

- ECB 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

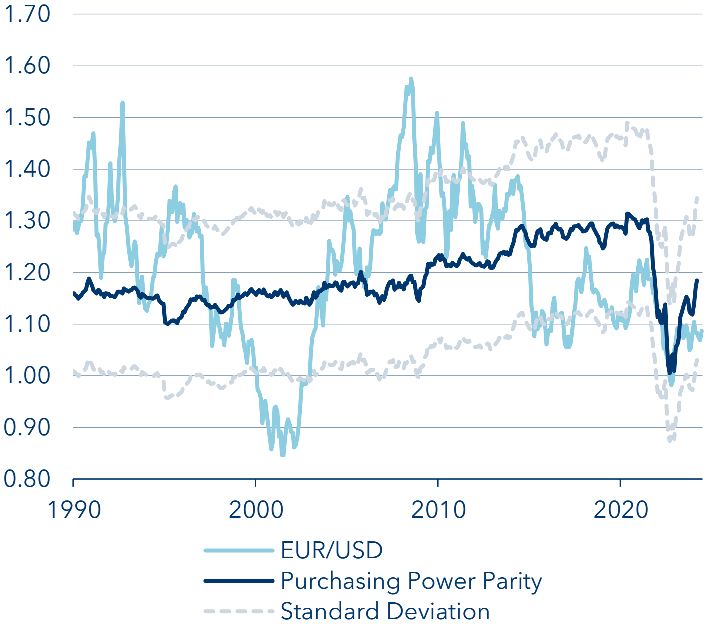
Dollar does not benefit from changed market expectations

The dollar has so far failed to benefit from the shift in US interest rate expectations. An easing in June is no longer an option and it remains questionable whether the Fed will cut rates at all this year. At the same time, the ECB cut its key rate by 25 basis points at its June meeting. Further rate cuts are expected later this year. One would expect the dollar to strengthen significantly as a result of the widening interest rate differential, but this is not happening at the moment. However, the currency markets are probably already thinking one step ahead. The longer the Fed funds rate remains high, the greater the medium-term risks to the US economy and the more significant the rate cuts could be later. This thinking is likely to be all the more true if, in the unlikely event, the Fed were to raise rates further.

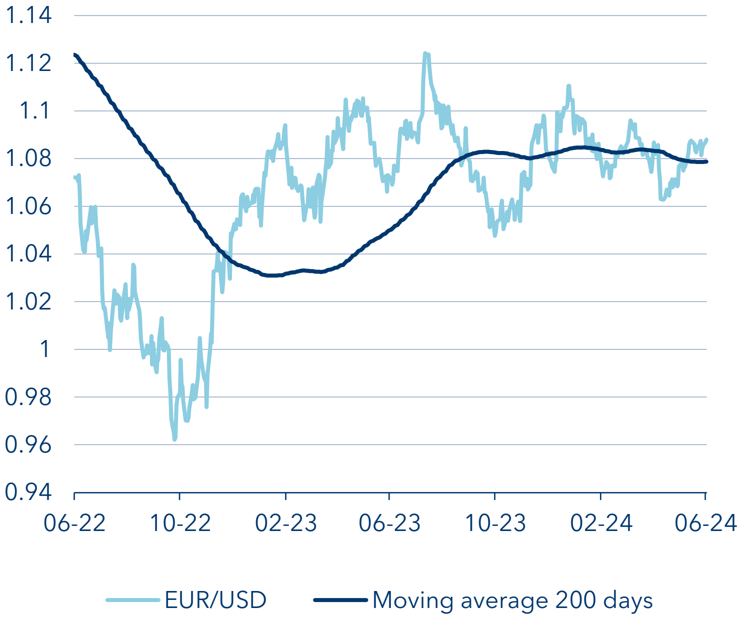
Our View on **EUR/USD**

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 ECB launches its first interest rate cut in June
- Purchasing power parity argues for a stronger franc
- The market technique shows a predominantly neutral picture

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

Low interest rates do not necessarily lead to depreciation

Although the Swiss franc weakened somewhat following the SNB's unexpectedly early 25 basis point rate cut in March, on balance it remained firm against the euro. A look at currency history shows that countries with low interest rates are characterised by a strong currency. This was particularly true of the Swiss franc, but also of the former Deutsche Mark. Low interest rates are an expression of low inflation, which also argues in favour of currency appreciation in terms of purchasing power parity. Interest rate cuts by the SNB therefore do not necessarily lead to a depreciation of the franc. On the contrary: in the long term, the signs point to further gains for the franc - not only against the euro, but also against the vast majority of currencies. Over the next three to six months, however, we expect the EUR/CHF to continue to trade sideways.

Our View on **EUR/CHF**

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Expected range
for 3 to 6 months

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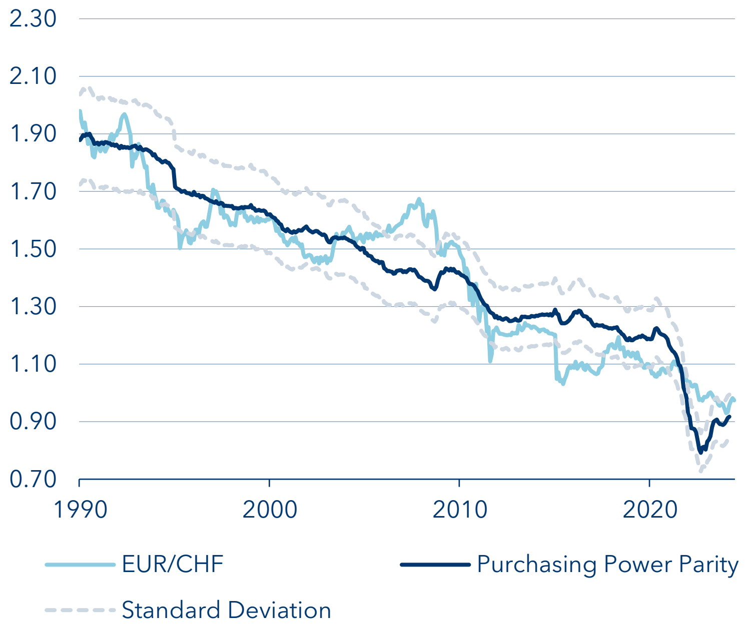

Technical view

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

Dollar is ahead

The dollar has been slightly ahead of the franc at times recently, trading just below 0.92. More recently, the franc has been slightly stronger. Fundamentally, however, geopolitical uncertainties - especially in the Middle East - are helping the greenback. The dollar is the main beneficiary of international conflicts. Another factor is that interest rates on the other side of the Atlantic are likely to remain high for some time to come. On the one hand, the US inflation rate has not fallen any further recently and, on the other, the US economy remains very robust. The Swiss franc area therefore remains attractive for carry trades. This involves borrowing cheaply in CHF and then swapping it for a higher-yielding currency, such as the dollar. In the short term, this tends to point to further moderate weakness of the franc against the dollar.

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0.86 - 0.94
Expected range
for 3 to 6 months

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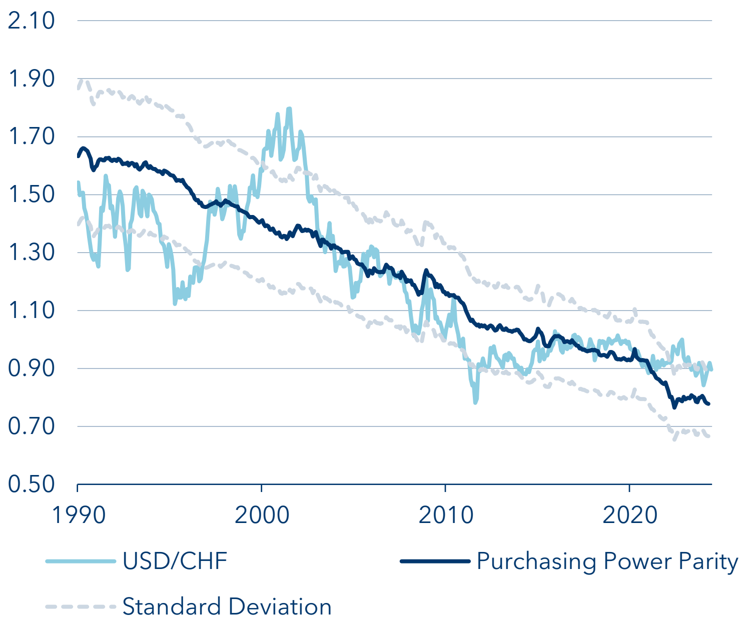

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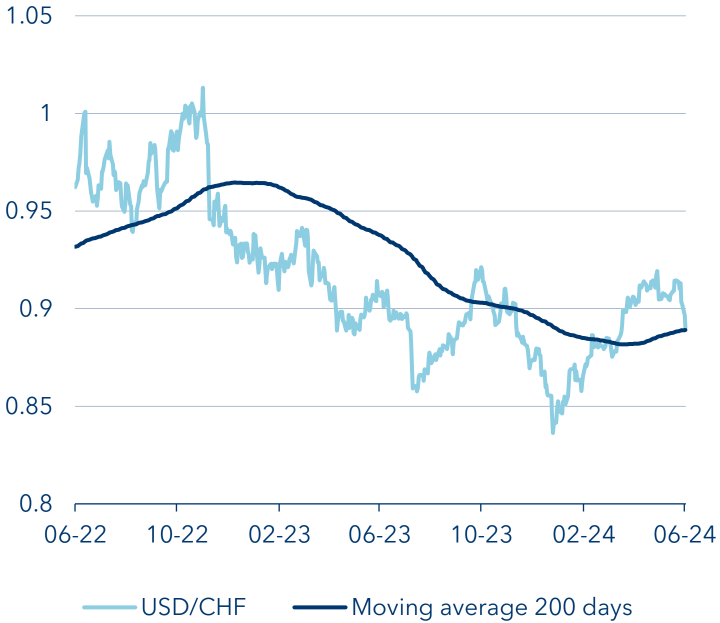

Our View on **GBP/USD**

1.23 – 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 weighing on sterling

UK inflation recently fell to a relatively low level of 2.3%. Excluding volatile energy and food prices (core rate), it was 3.9 %. Base effects could push inflation rates down further in the coming months, including the core rate. If the Bank of England (BoE) cuts interest rates by more than previously expected this year, this could weigh on the Pound. If, on the other hand, the BoE sticks to its stability-oriented stance and cuts interest rates more cautiously, the Pound could strengthen slightly over the summer months. This means that the path of interest rates will at least partially influence the Pound's exchange rate. However, comments from central bankers suggest that the key rate is likely to be cut significantly. This tends to reinforce the view that monetary policy is weighing on Sterling. Against this backdrop, we do not expect the Pound to rise above 1.30.

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Expected range
for 3 to 6 months

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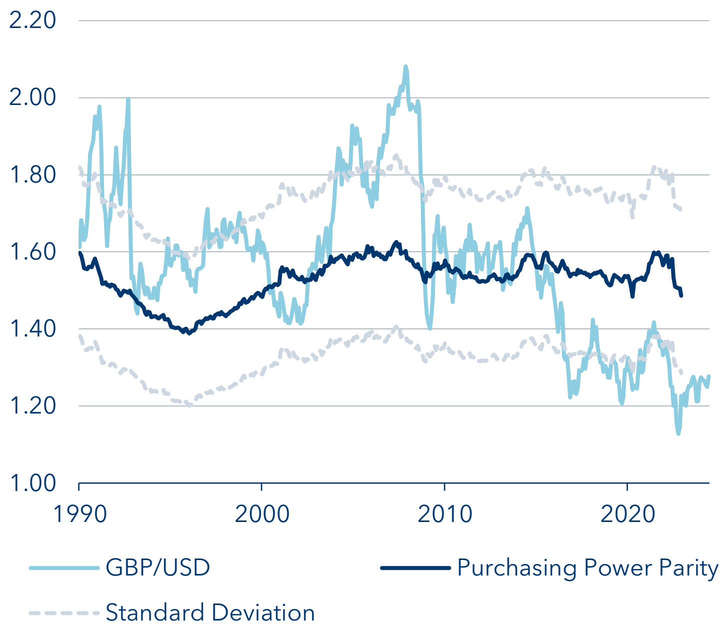

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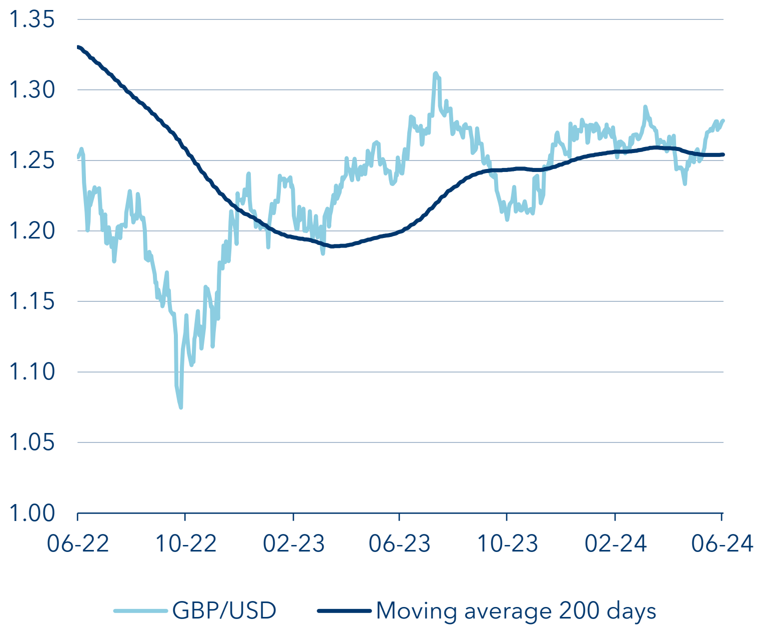

Our View on **EUR/SEK**

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
- Despite high inflation, the Swedish central bank sounds increasingly cautious about further interest rate hikes, which could weaken the SEK

No quick turnaround in sight

The Swedish central bank (Riksbank) cut its key interest rate by 25 basis points in May. This was the first rate cut since the inflation rate rose sharply to 12.2%. The Riksbank had previously raised the key interest rate to 4%. The latest inflation rate was 3.9 %. However, the Riksbank's preferred measure of inflation, the fixed-rate consumer price index (CPIF), was close to the central bank's target of 2 per cent at 2.3 per cent. The Riksbank therefore had the green light to cut interest rates. The interest rate cut was anticipated in the currency markets, i.e. the krona was not affected by the reduction in the key interest rate. In any case, monetary policy currently plays a secondary role for the krona. The Swedish krona stands to gain in an environment of a sustained global economic upturn. So far, there is no sign of this happening. We therefore do not expect the krona to appreciate significantly in the near future.

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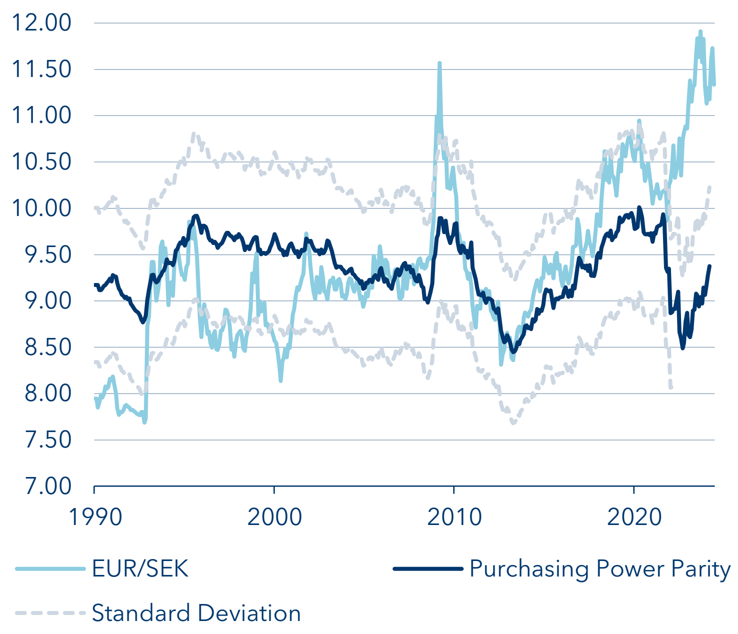

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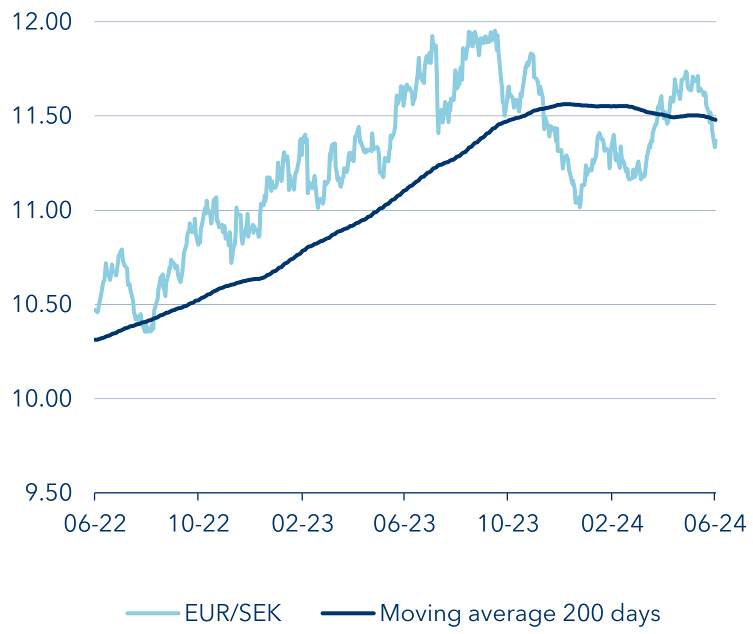

Authors and Disclaimer

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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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