Our View on Currencies

Edition February and March 2024

New year, new start

We expect interest rates to be cut from the middle of the year onwards, but not before. In the meantime, financial markets will continue to fret over timing. This will affect currency markets.

At the end of 2023, market expectations of monetary policy easing this year went into overdrive. Many, if not the majority, thought that central banks would loosen the reins in the first half of 2024, and that this would only be the beginning of a series of rate cuts. But investors exaggerated. So central bank representatives poured cold water on stretched expectations.

The President of the European Central Bank (ECB), Christine Lagarde, for one, said, that the first interest rate cuts should not be expected until the middle of the year. Meanwhile, currency markets remained relatively calm. In any case, there were no significant movements in exchange rates.

And since its still unclear when the first rate cuts will take place, no major bets are being made. This suggests that currency markets will continue move sideways.

Talking of unclear prospects: There is also a lot of guesswork as to whether the Japanese central bank will actually change tack on monetary policy at a time when other major central banks are moving to cut interest rates. Following a rise in inflation to a very high 4.3 % by Japanese standards, the pressure to act is easing now that the number has fallen back to below 3 %. In the short term, the yen will therefore unlikely to be supported by the Bank of Japans' monetary policy. However, in the medium term, the blatant undervaluation in terms of purchasing power parity favours gains in the yen.

Dr. Thomas Gitzel, **Chief Economist**

Our View on Currencies - Overview

Currency pairs

Our View on **EUR/USD**

1.06 – 1.14
Expected range
for 3 to 6 months

- ECB reached the rate peak in this cycle
- Speculative forward sales of the euro have largely been unwound
- Monetary policy no longer supports the dollar
- The dollar remains in demand as a safe haven in uncertain times

- Higher interest rate cuts by the ECB than previously expected could weaken the euro significantly
- Financial markets expect a soft landing for the US economy; a hard landing could weaken the dollar to a big extent

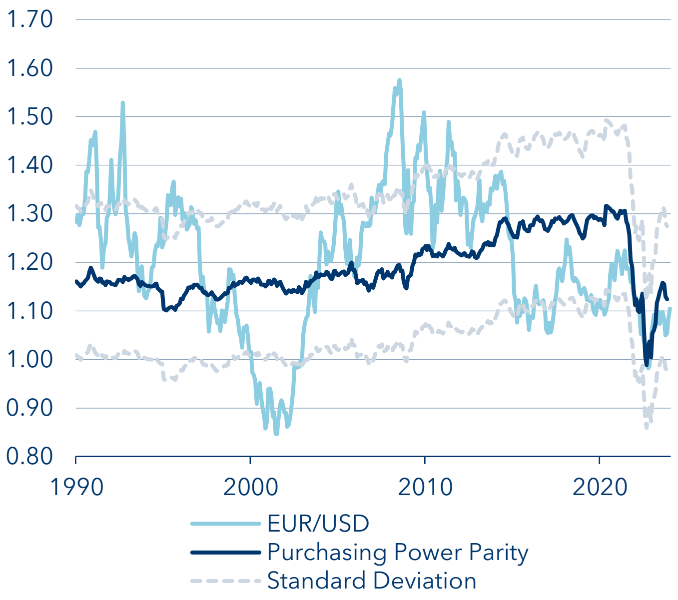
ECB likely to cut rates more sharply

The dollar weakened in the autumn months. This was due to emerging fantasies in markets of an early interest rate cut by the Fed. However, investors realised that the other central banks would not remain inactive. This applies to the European Central Banks (ECB) in particular. We expect the ECB to cut interest rates more sharply than the Fed. This should prevent a more sustained slide in the dollar. And something else counts: Geopolitical uncertainties are and will stay high, which is why the greenback will remain in demand because it is a safe haven. For the time being, currency markets are likely to hold back from taking a clear view for or against the dollar. In any case, we see our expectation of a sideways move confirmed and are sticking to it.

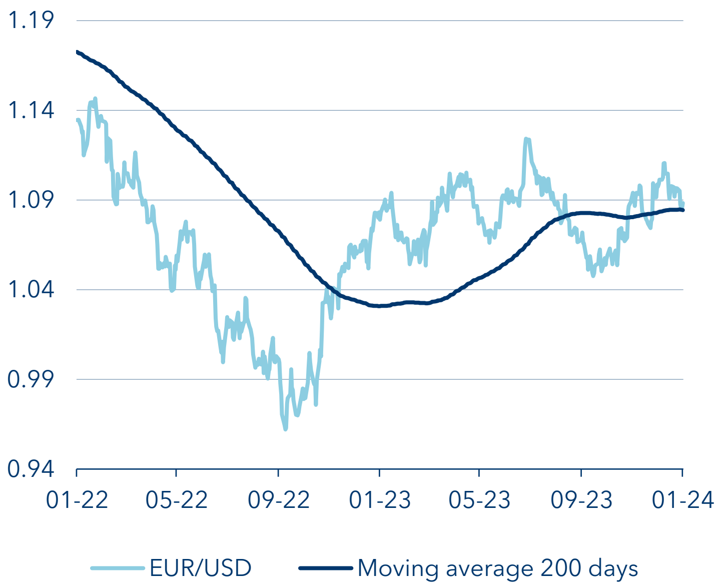
Our View on **EUR/USD**

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**

0.93 – 0.98
Expected range
for 3 to 6 months

- SNB likely to hold back on interest rate cuts this year
- EUR/CHF pair is largely unaffected by monetary policy for the time being

- If the ECB were to decide to cut interest rates early, the euro would weaken significantly
- A sudden flight to safety would weaken the euro against the franc

Declining inflation will prevent significant euro strength

Contrary to our expectations, the Swiss franc continued to appreciate and even reached new all-time highs against the euro. The franc thus broke out of our forecast range. This is directly linked to the expectations for interest rate cuts by the ECB that emerged towards the end of last year. These went too far which is why ECB president Christine Lagarde felt compelled to intervene verbally. Her message is, that an interest rate cut can be expected as of the middle of this year, not earlier. As a result, the euro re-gained some strength. However, we do not expect the euro to strengthen significantly, as the Euro area core inflation rate will continue to fall in the coming months, fueling the prospect of interest rate cuts. We are adjusting our forecast range slightly downwards and continue to expect a sideways move.

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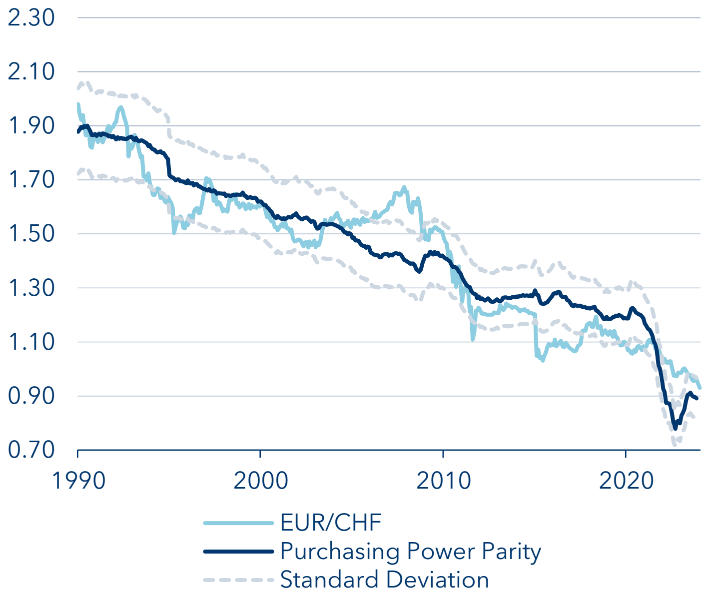

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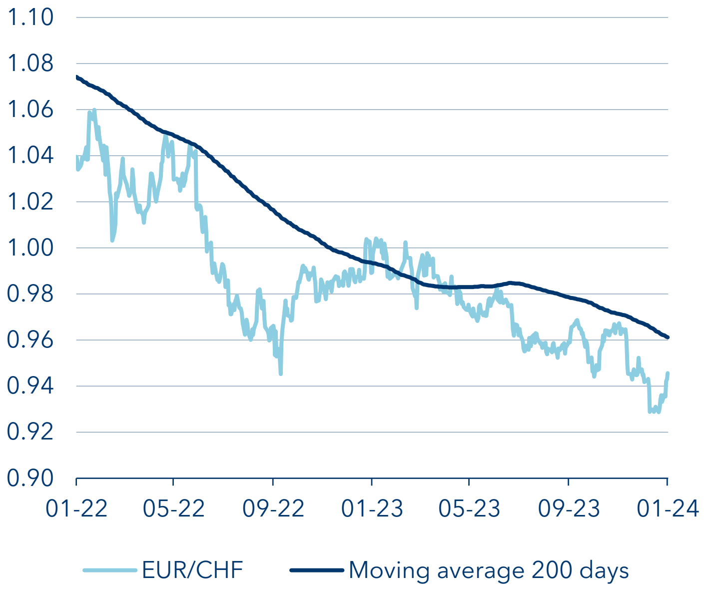

Our View on **USD/CHF**

0.84 - 0.92
Expected range
for 3 to 6 months

- Both currencies are in demand in times of high uncertainty
- The dollar is weakened by interest rate cut fantasies

- If risk aversion sets in, the dollar would be ahead of the franc
- If the SNB were to signal the prospect of rate cuts in view of low inflation rates, this could weaken the CHF

Rate cut expectations weigh on USD

The franc also strengthened against the dollar at the end of 2023 in the wake of the rate cut expectations for 2024. However, the bets on falling interest rates appear to have overshot the mark. In our view, the Fed will not start easing before summer. The risks of inflation have not yet been completely averted and, in view of the significant rise in inflation over the last two years, the Fed will want to make sure that inflation has been beaten before it cuts interest rates for the first time. This opens the scope for a moderate dollar strength in the coming weeks, also suggested by the overstretched technical situation. Slightly higher prices for the USD/CHF pair therefore seem likely for us. However, the dollar's strength should only be of limited duration, as rate cuts by the Fed could weaken the dollar.

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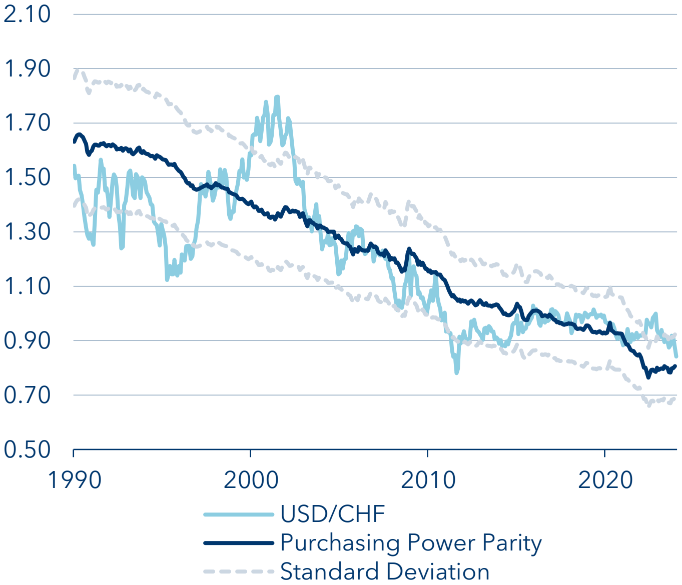

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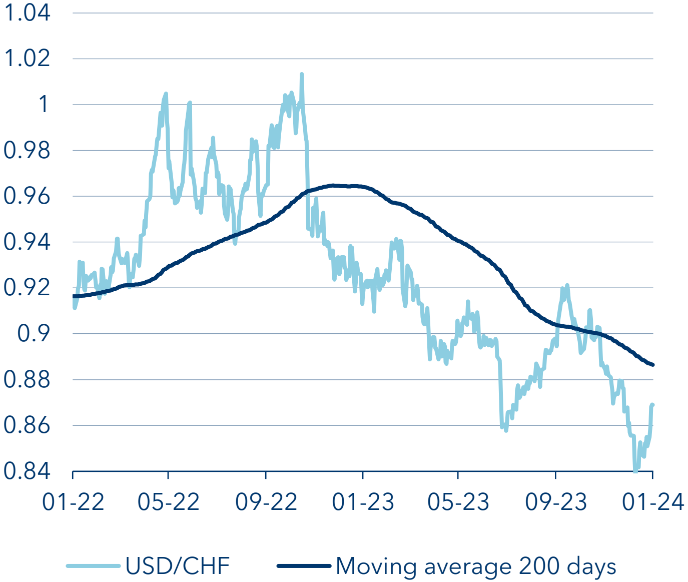

Our View on **GBP/USD**

1.22 – 1.30
Expected range
for 3 to 6 months

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

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

Hardly any recovery potential for the pound

The pound was able to make up some ground against the dollar in line with other currencies. However, we do not expect the British currency to stage a sustained recovery against the greenback. The islands' economy is subject to a variety of structural growth challenges. Brexit in particular is weighing heavy. The risk of inflation is also far from over. Inflation is still at 4%. When volatile energy and food prices are factored out, the rate is still above 5%. This means that the British central bank will not be able to provide monetary policy support in the event of economic weakness. With a view of the economic factors, we consider the potential for an appreciation of GBP to be limited. In our view, sustained levels of over 1.30 against the dollar are unlikely at present.

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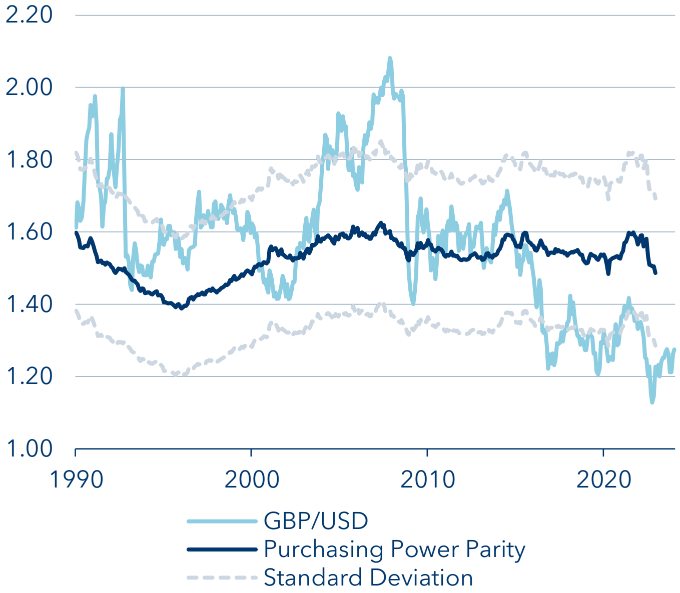

Technical view

Our View on **EUR/SEK**

10.80 – 11.50
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

Weakness of the krona is not a weakness of the Riksbank

In many places, the current weakness of the krona is being attributed to the Swedish central bank's lack of vigour in countering the rise in inflation. In our view, however, this falls short of the mark. The Swedish krona has been on a downward trend since 2013. This applies not only against the euro, but also against the dollar. The krona is considered a high-beta currency. It benefits in an environment of a sustained global economic upswing accompanied by low geopolitical risks. However, the last few years have been characterised by numerous crises with high political risks. In such a climate, sustained gains for the krona are not possible. On the other hand, the favourable valuations argue against further significant weakness of the krona. We are likely to see the EUR/SEK currency pair in an even longer-lasting top formation.

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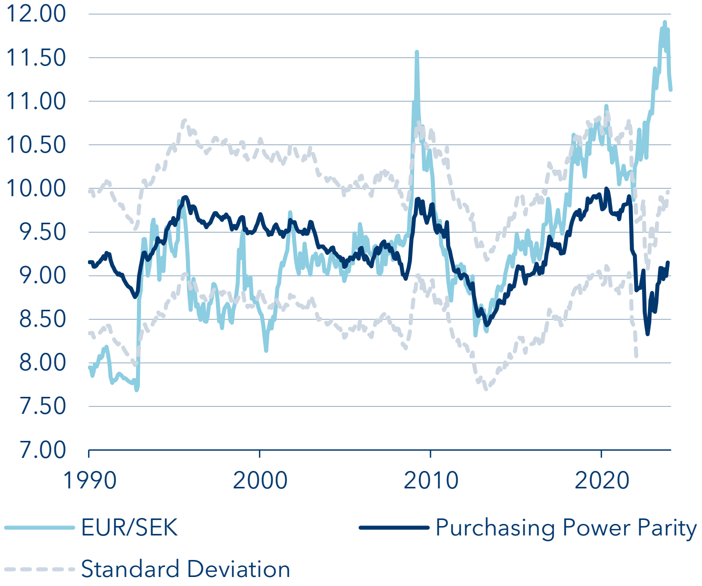

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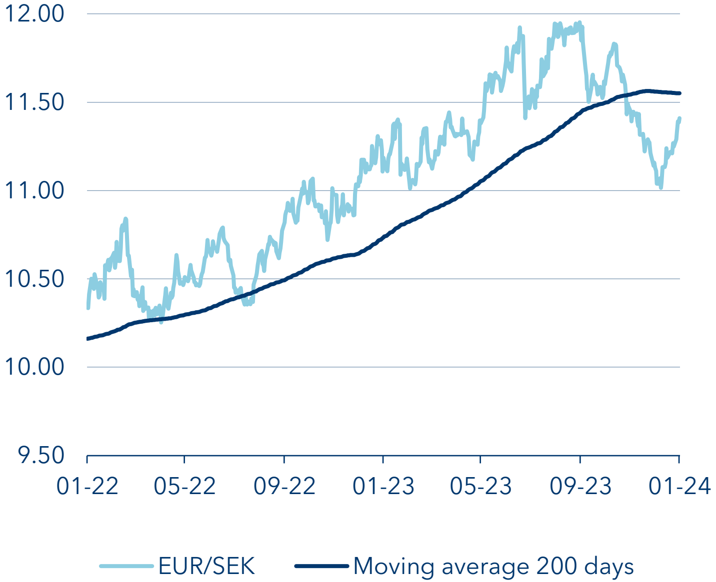

Authors and Disclaimer

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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