News from the financial markets

ECB aims to change the wording of its guidance – effects on EUR/USD and EUR/CHF

EUR continues to flex its muscles. The common currency has appreciated across the board and in the process surpassed the technically crucial 1.2050 level versus USD. The reason: a potential change in the ECB's communication strategy. In the short term, this clears the way for a move towards the 1.25 mark. However, there are still many fundamental arguments in favour of a depreciation of the EUR – against both the greenback and CHF.

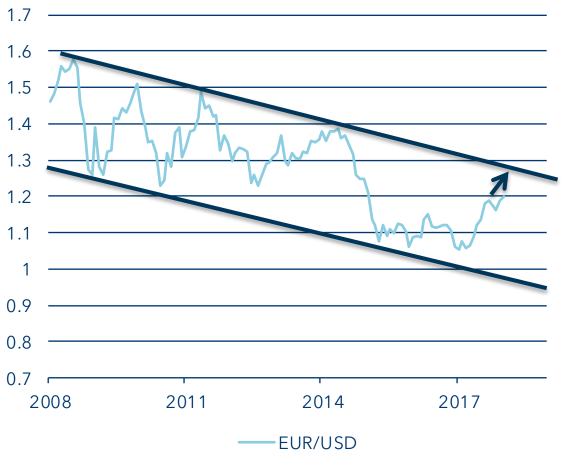
ECB minutes reveal strategy change

The euro has continued to flex its muscles in recent months as it benefits from the extremely upbeat array of macroeconomic data coming from the euro zone. The ECB has also played its part: the minutes of Governing Council's December monetary policy meeting revealed that discussions on a change of its phraseology had already taken place, and this more intensively than expected. According to certain officials' comments, such a step could take place already in the coming weeks. So what does this mean concretely? Presumably, the ECB would initially refrain from constantly reiterating that bond purchases will continue until the Governing Council ascertains a sustained rise in inflationary trends. Such a terminological twist would conveniently enable Frankfurt's currency regulators to cease the bond purchases (currently EUR 30 billion per month) without by necessity waiting until the desired inflation rate of ca. 2% has actually been reached. This would represent a clear break with previous practice. In consequence it is quite conceivable that, going forward, Mario Draghi will refer more to the inflation outlook and less to the present state of inflation. This considerably expands the ECB's room for manoeuvre, for example the freedom to cease entirely its monthly purchases of securities by September – even if inflation continues to be sluggish. There has even been speculation in the financial markets that the central bankers could start to "normalise" interest rates already by the end of 2018. The implicit probability of an ECB interest rate hike in December 2018, as reflected in the futures markets, spiked to 60% after publication of the meeting minutes.

EUR: upside momentum persists

From a technical point of view, the penetration of resistance around 1.2050-80 clears the path for a move in the direction of 1.25. We believe it is realistic to expect that this mark could be reached in the short term, since the market's extremely euphoric EUR sentiment is likely to continue. From a fundamental perspective, the move is likely to be accompanied by the rekindled discussion of an earlier than anticipated ECB rate hike. Although we still do not expect to see an increase in European interest rates until 2019, speculation alone could carry the common currency to greater heights.

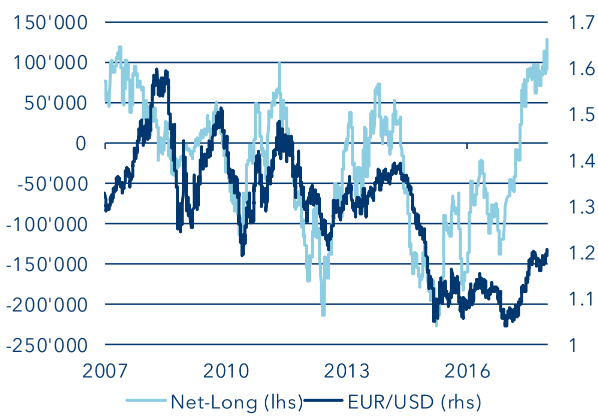
EUR/USD trend channel



USD side should not be disregarded

Although the markets can be expected to focus increasingly on ECB manoeuvrings in the coming weeks, a blind eye should not be turned on the Fed – the positive flow of news is likely to continue also on the other side of the pond, where the US economy is picking up a head of steam. Donald Trump's tax reform has the potential to accelerate growth in capital spending, and the US Federal Reserve will almost certainly continue along its path of rate normalisation – with the net result being a widening of the interest rate differential between the USA and the eurozone. Especially the latter aspect argues in favour of a considerably stronger greenback. It should also be borne in mind that speculative investors are relying heavily on a continuation of the weakness in USD and strength in EUR, as reflected by the record number of net longs in EUR/USD (see chart).

EUR/USD and net-long futures contracts



This lopsided positioning raises a caution flag, though. Any unexpected newsflow that calls into question the further upside potential of EUR/USD would be reason to unwind these speculative positions, in which case significant losses in EUR or, as it were, gains in USD are predestined.

Current appraisal of EUR/USD

At present it is hard to ignore the fact that market forces are attempting to push EUR to new heights. This has been signalled clearly by the penetration of stiff technical resistance at 1.2050-80, a development that means a test of the 1.25 mark needs to be factored-in for the short term. Support for the move is likely to come from speculation about an ECB interest rate hike. The protocol of the Governing Council's latest meeting reveals a willingness to alter the wording of the ECB's communiqués. Be that as it may, the interest rate differentials in fact suggest a weaker EUR versus a stronger USD. The record number of speculative long EUR/USD positions in the face of ever-higher quotations also raises a flag of caution, given its nature as a contrarian indicator. We therefore continue to expect lower EUR/USD exchange rates three to six months out. However, as we assume that the positive EUR momentum will initially prevail for the next several weeks, our originally projected price target for EUR/USD (1.08 - 1.10) is no longer tenable. We now expect to see the currency pair trade in a range between 1.15 and 1.17 over the longer term.

Current appraisal of EUR/CHF

Our adjusted estimate for EUR versus USD also has implications for the EUR/CHF cross. A close correlation between EUR/USD and EUR/CHF has been observable for quite some years now. This is understandable economically, because ultimately what lies behind this parallel movement is the general strength or, as it were, weakness of the euro. If speculation about an early interest rate hike by the ECB intensifies in the weeks ahead, EUR can be expected to take aim at the 1.20 mark against CHF. However, the general correction in EUR that we foresee 3 to 6 months down the road will likely result in lower prices for the EUR/CHF currency pair. We are looking for the cross to settle into a range between 1.14 and 1.17 at that point.

Summary

The EUR's strapping vigour is likely to persist for the time being, even though it is not justifiable from a fundamental standpoint. However, we need to pay tribute to this positive market momentum. In the short term, EUR should remain strong, not least of all due to the renewed talk about a sooner than previously anticipated ECB interest rate hike. Three to six months out, though, the euro should start to suffer some muscle atrophy, at least for a certain time.

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