GENERALI INSURANCE ASSET MANAGEMENT

FOCAL POINT

EUR/USD: still upside through the banking woes

Thomas Hempell

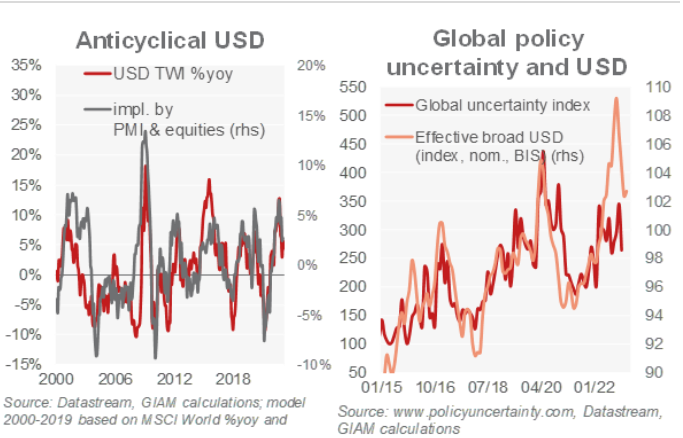
March 30, 2023

Our Focal Point series explores topical issues on macro, markets and investment

- **The USD is a countercyclical currency, usually benefitting from global growth weakness and financial stress.**
- **Yet barring a severe escalation of banking woes, we expect a weaker dollar and a higher EUR/USD by year-end.**
- **The Fed is likely done with its rate hikes as tighter credit conditions kick in and a recession is looming. A pivot as soon as in Q4 will mean that yield gaps vs. the euro area will tighten, a EUR positive.**
- **With central banks reaching peak rates and inflation (sluggishly) easing, yield volatility is set to recede, removing a key pillar that drove the USD further into overvaluation in 2022. By contrast, the EUR will benefit from resuming capital inflows, a fading terms of trade shock, and the ECB's more persistent hawkish tilt.**
- **The main risk to our constructive EUR/USD view is the tail risk of a very severe escalation of the banking crisis, with safe-haven flows dwarfing other FX drivers. Should euro area bank stress rise materially and revive the bank-sovereign doom loop, the EUR would suffer more materially.**

The Western banking woes in the wake of collapsing SVB in the US and Credit Suisse in Switzerland have pressured bank assets and boosted safe-haven core bonds and the JPY. Yet the greenback did not benefit – the Dollar index (DXY) is even down 3% since March 8 (before reports of severe trouble at SVB).

This is striking, as the USD is usually sought as a countercyclical currency, benefitting from economic and financial woes, rising risk aversion, and policy uncertainty (see charts). As we lay out in this report, the next months are likely to give way to an even weaker USD and higher EUR/USD by year-end.



Source: Datastream, GIAM calculations; model 2000-2019 based on MSCI World %yoy and

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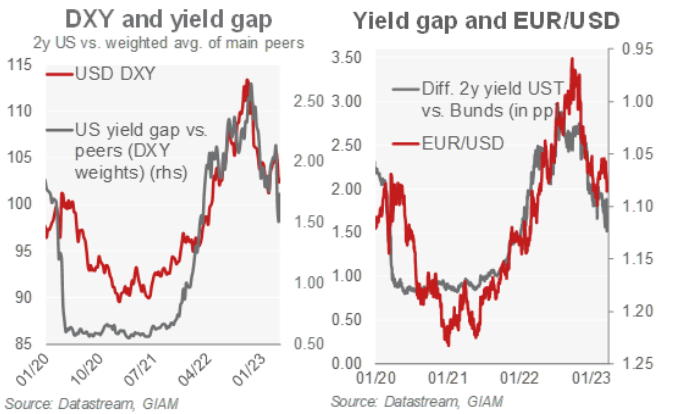
Credit squeeze substituting for Fed hikes

Much of investors' USD neglect relates to the specifics of this crisis. It originated at troubled US lenders (SVB, Signature) and laid bare vulnerabilities of less tightly regulated US small and mid-sized banks. But most intense worries still centre around small and mid-sized US banks and their strong connection to commercial real estate, which many fear could be the next shoe to drop.

Given high uncertainties, we expect the woes in the US financial system to persist amid mounting evidence of deposit flight. European banks are more tightly regulated and better capitalized. But the stronger investor scrutiny of the whole sector battered banking stocks also in Europe and sank Credit Suisse, which suffered from scandals and an increasingly flawed business model.

This complicates central banks' tasks on both sides of the Atlantic. To not fuel market panic, both the ECB and Fed stuck to their guns in their inflation fight in March and hiked rates further – while switching to fully data-dependent guidance. Both flagged the stability of their banking sectors and the availability of sizeable liquidity measures if needed. But they also implicitly acknowledged that tighter credit conditions will weigh on the outlook and may substitute for further rate hikes.

This substitution of further rates by tighter credit conditions holds most notably for the Fed, where the credit squeeze by small and mid-sized banks should be felt soon. As the crisis keeps lingering, we expect tighter credit conditions to stop the Fed's tightening at the rate levels just reached.

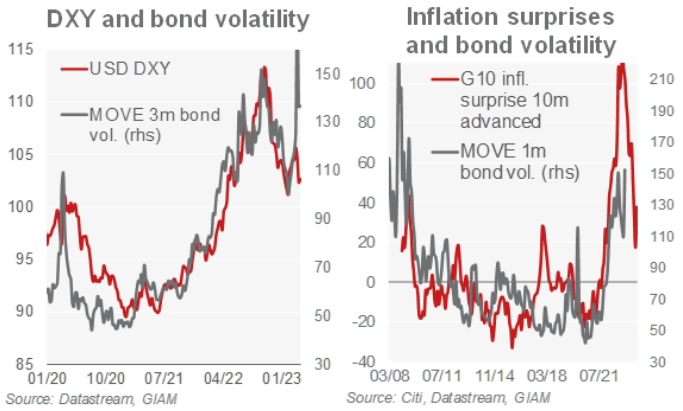


The FX implications from this 'switch' in tightening forces are strong, as the earlier USD boost from higher rates is turning into a drag from tighter credit conditions. Markets barely price any further Fed hikes neither, so the pure surprise effect may be small. But the full impact from the looming credit crunch may still adversely impact the USD.

Eroding pillars of USD strength

In fact, the financial woes are likely to bring forward and deepen the looming US recession. We have shelved our 2023 growth by 0.7pp to a below-consensus 0.4%. The more marked recession may have the Fed cut the fed funds rate by 50bp in Q4 and another 175bp in 2024, much deeper and earlier than the 25-50bp rates reversal foreseen for the ECB only later in 2024. This will trigger a marked narrowing in the US/EA 2-year yield gap by at least 40bp. The strong widening of this yield gap amid the Fed's lead in the tightening cycle was the first of two major pillars of USD strength in 2022 (see charts on the left).

The massive global inflation overshoot and central bank response were the second pillar as yield uncertainty triggered safe-haven demand for the USD (left chart below). The divergent challenges to central banks from stubborn inflation (requiring persistent tightness) and banking worries (calling for prudence) have created new uncertainties and helped the USD to defy the drag from narrowing yield differentials shown in the yields/FX charts above. These uncertainties may persist for a while as banking worries and central bank



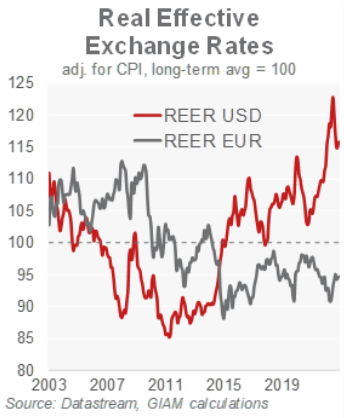
dilemmas are unlikely to dissipate quickly. Ultimately, however, we expect the – admittedly bumpy – disinflation path to bring yield uncertainty down again (right chart above) thereby easing safe-haven bids for the USD.

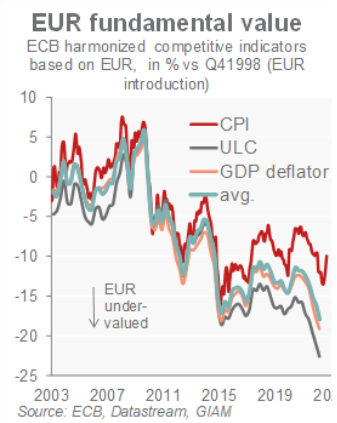
EUR support from fading terms of trade shock

Meanwhile, the EUR seems headed for more genuine strength too. The single currency is cheap on many dimensions (charts below), while the USD is dear.

A major drag on the EUR over the past year was the massive terms of trade shock (chart below) as the cut Russian gas supply sent the bills for energy imports soaring. Concerns about gas supply into next winter persist, but overall energy worries for Europe are unlikely to reach uncertainties and bills seen last autumn, with energy (and overall commodity) prices back well below levels prevailing before the invasion.

Capital inflows may also resume, as energy uncertainties subside. Even if the recovery will be dampened by the fallout from the huge monetary tightening and banking woes, net FDI outflows are more likely to normalize or even turn slightly

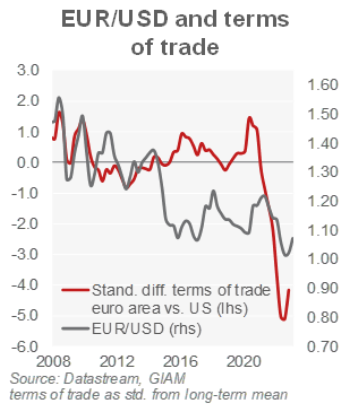


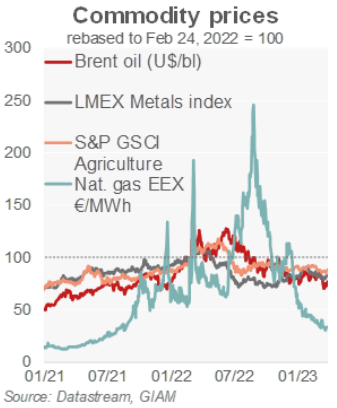


positive going forward (left chart below)

Momentum is on the EUR side as well. A simple trading rule to be overweight (underweight) EUR/USD any time the cross is above (below) its 200-day average has been rendering steady returns over the past 20 years (top right chart).

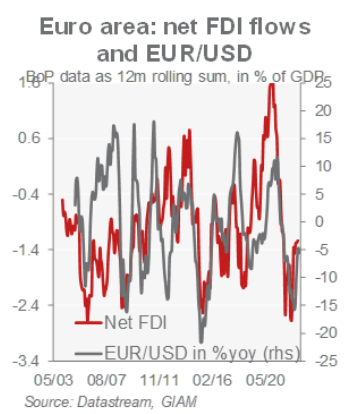
Positioning to slow the ascent

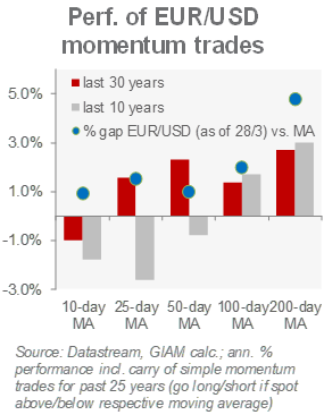




The EUR/USD ascent is unlikely to be smooth, though, given the persistent uncertainty from the banking woes, sticky inflation, and shaky risk sentiment. Positioning is also a point of concern near term, as EUR shorts have rapidly swung into longs, bearing the risk of a correction. Yet this EUR long bias is not so much reflected any longer in the misalignment vs. yield differentials on a rolling basis, suggesting that a moderate reversal of EUR longs may not hurt the EUR/USD (right chart below).

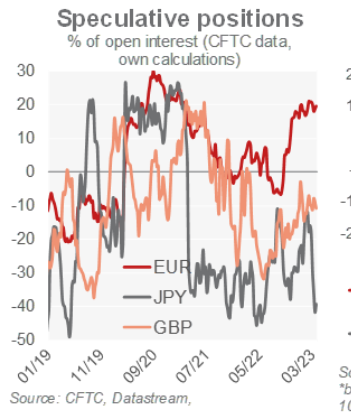
Overall, while near-term gains seem limited, we expect the EUR/USD to settle in the 1.10-1.15 range by year-end.

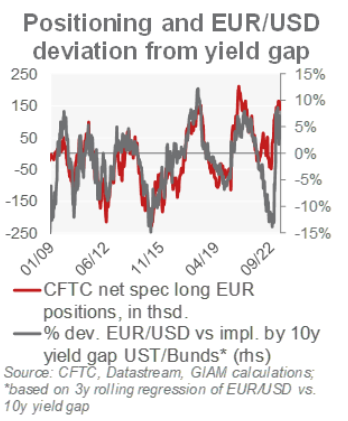




Risks to the view

What could derail the constructive view for the EUR/USD? Apart from a new escalation of the Russian aggression in Ukraine, a severe deterioration of the banking crisis would reverse the EUR/USD rise. Even though the biggest risks





seem to be centred at US small and mid-sized banks, severe global financial stress would trigger broad-based safe-haven flows. Resulting USD strength may still be cushioned by disproportionate rate cuts by the Fed. (With US rates at almost 5%, it has much more scope to slash rates than most peers.) Yet a full-blown banking crisis in Europe could reignite worries about a persistent sovereign-bank loop – and turn the focus of worries from the US to the single currency.

Imprint

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