Global Economics & Markets Research
Email: GlobalEcoMktResearch@uobgroup.com
URL: www.uob.com.sg/research

Macro + FX Strategy Note

Reiterating Our Bullish EUR/USD Call

Monday, 15 January 2018

Lee Sue Ann
Economist
Lee.SueAnn@uobgroup.com

Heng Koon How, CAIA
Head of Markets Strategy
Heng.KoonHow@uobgroup.com

Peter Chia
Senior FX Strategist
Peter.ChiaCS@uobgroup.com

Quek Ser Leang
Markets Strategist
Quek.SerLeang@uobgroup.com

- EUR/USD jumped to 3-year highs above 1.22 after Merkel's breakthrough and hawkish ECB minutes.
- The move is supported by record positioning and improving yield spread although the former is probably overstretched.
- We reiterate our EUR/USD forecast at 1.23 by end 2018 as we hesitate to write off the USD as yet.

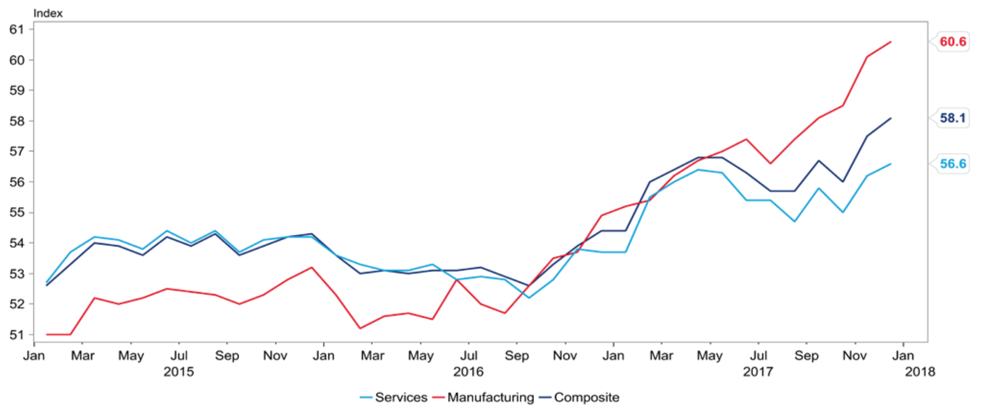
EUR/USD Took Flight After Political Gridlock Abates And Hawkish ECB Minutes

The rally in EUR/USD roars back to life after the pair took out the previous high of 1.2092 (last seen in Sept) and surged 1.2% to close 1.2185 on Friday. This came on the back of news that German Chancellor Angela Merkel has managed to reach an in-principle deal with the Social Democrats (SPD) on Friday to start formal coalition talks that could lead to a new coalition government, ending four months of political gridlock. The SPD party convention this Sunday (21-Jan) is very likely to give the go-ahead for formal coalition negotiations. If all things proceed smoothly, a draft of the coalition treaty should be finalized by end-February. After which, a CDU party convention and a SPD members' ballot will have to approve the draft before Merkel can be reelected as Chancellor of a renewed grand coalition by mid- or end-March. But a veto from the SPD members remains a risk and should it occur, new elections seem to be more probable than a CDU/CSU minority government.

Before the positive political developments on Friday, the EUR already had a boost on Thursday firming back above 1.20 after the European Central Bank (ECB)'s December meeting minutes was more hawkish than anticipated. The minutes showed officials could revise language around policy stance earlier than thought if Eurozone's economy and inflation continue to improve.

Chart 1: Euro area's Rising PMIs Suggest Broadening Recovery

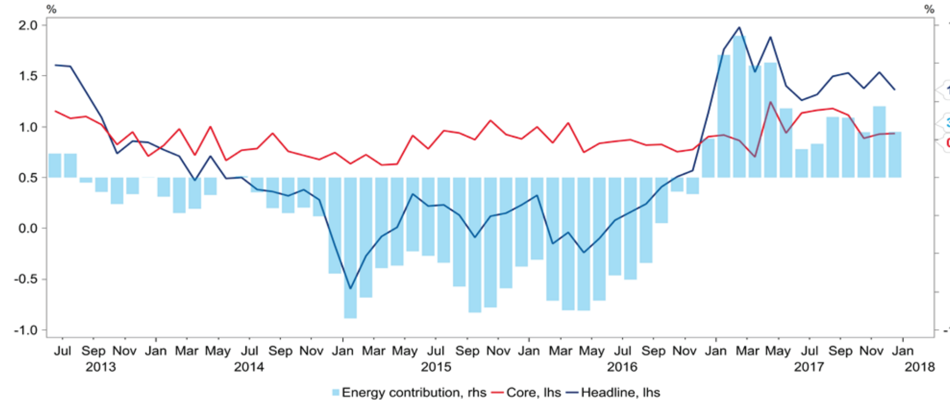
Source: Macrobond, UOB Global Economics & Markets Research



Already we had the Eurozone manufacturing PMI hitting its all-time high of 60.6 in December. In all, we continue to hold the view (since last October) that bond purchases by the ECB will eventually fall to zero (current pace: €30 bln per month) after September 2018, especially if the Eurozone recovery continues and the slack is absorbed.

Chart 2: Euro area's Inflation Likely To Continue Stabilizing In 2018, Paving The Way For Withdrawal Of Monetary Stimulus

Source: Macrobond, UOB Global Economics & Markets Research



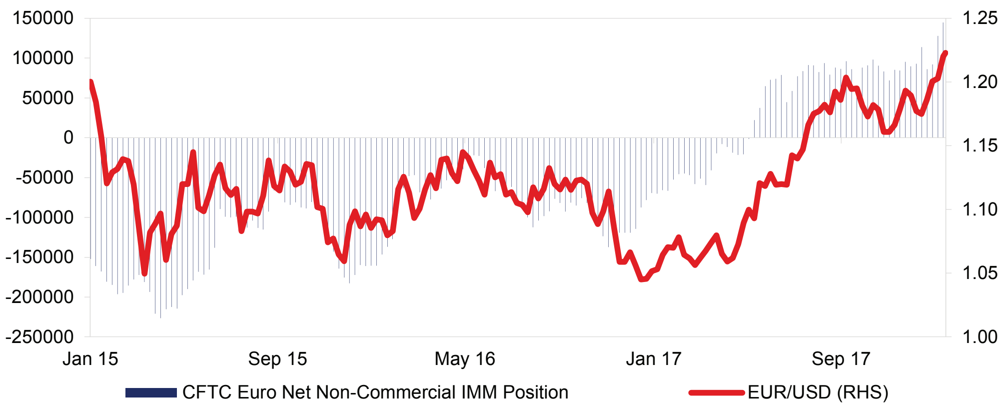
Record Positioning In EUR

Even before the new catalysts arrived late last week, speculators have already been the most bullish EUR/USD on record in the first two weeks of the year. The latest weekly CFTC report as at 9-Jan showed non-commercials maintain a record net long EUR/USD positioning of almost 145k contracts, surpassing the previous record of 114k set in mid-December.

Given the 2 big figure move since last Thursday, it is highly likely the record net longs would extend further which in turn would support the EUR/USD. Our technical analyst sees an extension of the current move towards 1.23. Perhaps the only party stopper is the severely overbought conditions, with the 90-day Z score already at 3 standard deviations above the mean. Similar episode in EUR/USD last May resulted in a 1-month sideways consolidation before a resumption of the rally.

Chart 3: EUR/USD Boosted By Record Speculative Longs

Source: Bloomberg, UOB Global Economics & Markets Research



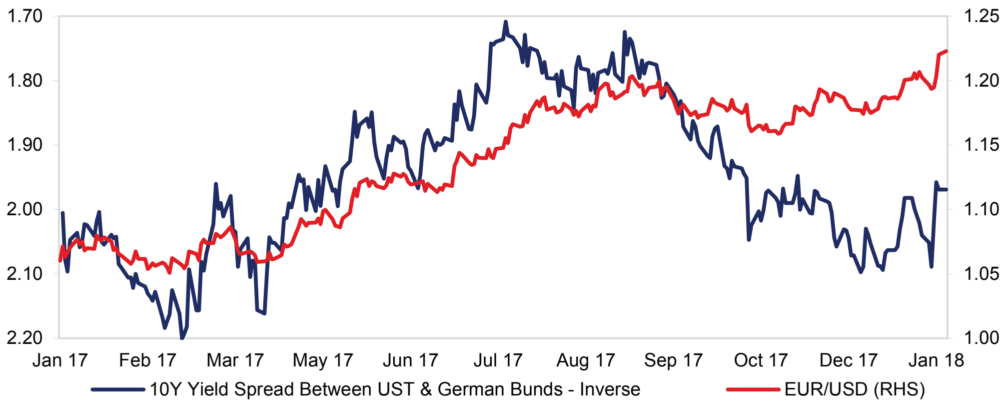
10-Year Yield Spread Has Started To Favor EUR/USD

Since the dovish tapering announcement by ECB in late October, the spread between the 10-yr UST and German bunds has been deteriorating against the EUR. The spread widened out to as much as 2.10% in mid-December.

In the first two weeks of the year, both the UST and German bund yields moved higher as investors repriced that broadening global growth would eventually spur inflation. The 10-yr bund spiked to last July's high of 0.60% last week while the 10-yr UST is guided higher from 2.40% end 2017 to 2.55% last week. Overall, the spread has narrowed to 1.97% and should gradually tilt in EUR/USD favor going forth.

Chart 4: Yield Spread Tilting In EUR/USD Favor

Source: Bloomberg, UOB Global Economics & Markets Research



Sentiments For USD Remain Weak

Evidently, EUR/USD is well-supported as sentiment for broad dollar remains weak. After dropping almost 10% in 2017, there is still no bottoming of the USD as yet. This comes amid Congress passing the widely anticipated tax reform in December and increasing prospects for further Fed rate hikes this year. In 2018, the Fed is clearly not the only game in town and more central banks will jump on the bandwagon to raise rates as the global recovery broadens and deepens. Until US inflation returns or tightening effects of Fed's Balance Sheet Reduction (BSR) emerge, the USD is likely to be on the defensive. (For more details, pls read "Why Is The US Dollar So Weak?" dated 3 Jan)

Overall, Reiterate EUR/USD At 1.23 By End-2018

With the move in the past week, EUR/USD has already surpassed our end 3Q18 forecast of 1.21 and is within closing distance to our end 2018 forecast of 1.23. That said, we are still keeping to the current set of forecasts. On the upside, EUR/USD should continue to be supported by CFTC positioning and improving yield spread although the former is probably overstretched as argued earlier. In fact, at next week's ECB meeting, President Draghi may make use of the occasion to curb enthusiasm of EUR bulls.

More importantly, despite the excessive selling pressures, we are not writing off the USD as yet. With the Fed on track for 3 rate hikes this year, together with BSR and eventual USD repatriation from US corporates, further EUR/USD gains should slow from here. Until new factors enter the markets, we reiterate our EUR/USD forecast at 1.23 by end 2018 and will review the call at the next quarterly report.

EUR Has Re-Entered Bullish Phase, Next Level To Watch Is At 1.2300

Source: Reuters, UOB Global Economics & Markets Research

While we highlighted the improving odds for further EUR strength last Friday (12 Jan, spot at 1.2035), the rapid acceleration higher that sliced through the key 1.2100 level came as a surprise. The neutral consolidation phase ended sooner than anticipated and from here, EUR is deemed to have re-entered a bullish phase (a couple of 'targets' were already exceeded as EUR hit a high of 1.2211 this morning).

In view of the sharp and 'one-way' decline in EUR back in 2014 and 2015, the next significant resistance on the weekly chart is much further up at 1.2780 (declining trend-line that is near the minor low in 2013). For now, we will use the 'round number' 1.2300 as the next target. 'Stop-loss' is placed at 1.2030 and this level is likely to move higher quickly in the coming days. On a shorter-term note, 1.2120 is already a strong level.

Recent Publications

15 Jan Indonesia: Exports Grew Slower At Year-End, Trade Balance In Deficit
12 Jan Macro+FX Strategy Note: USD/JPY Risks A Deeper Correction To 108
10 Jan FX Strategy: Is 6.50 The Line In The Sand For USD/CNY?
09 Jan Indonesia: Foreign Reserves Reached Fresh Record High Level
08 Jan Indonesia: Dec Consumer Confidence Indicated Optimism