EUR-USD: on the highway to fair value

by Vasileios Gkionakis (UniCredit Bank, London)

- We raise our EUR-USD forecasts to 1.20 for end-2017 (1.14 previously) and 1.25 for end-2018 (1.18 previously), bringing it in line with our estimate of fair value
- The ECB's "currency pain threshold" appears to have risen (as a reaction to a more-solid economic outlook), which should allow the exchange rate to converge towards equilibrium at a more rapid pace than we initially thought
- On top of this, we do not expect any halt or reversal to the TW USD downward correction (still around 8% overvalued) as the US administration keeps stumbling from one mess to the next
- Together with some fine-tuning to a number of our other USD forecasts, our EUR-USD targets imply that the TW EUR will appreciate another 2% by year-end and a further 2.5% in the course of 2018
- Naturally, there are both downside and upside risks to our view. On balance, we think risks are slightly skewed to the latter: history suggests that once the convergence process begins in earnest, it tends to overshoot equilibrium

EUR-USD's convergence to equilibrium has begun in earnest

We now find ourselves in what seems to be a sort of "nice-to-have" problem: when in late 2016 we discussed stretched USD overvaluation/euro undervaluation and articulated our concerns about the market's interpretation of the Trump effect on asset prices, we raised eyebrows. Indeed, even we ourselves were quite cautious back then as contemplating dollar weakness felt like standing in front of a runaway train.

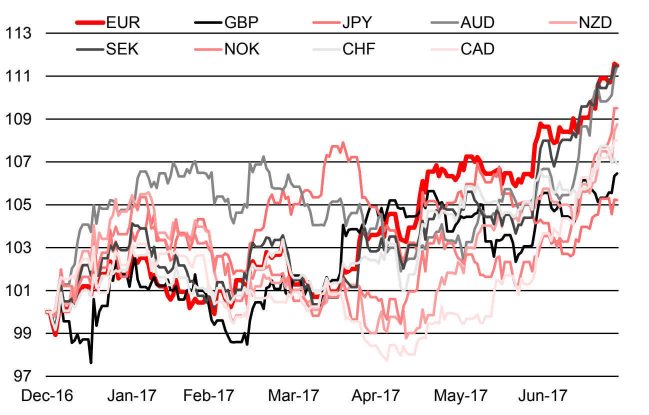
Eight months later and the dollar has lost 8.5% in trade-weighted terms, EUR-USD has risen by 11.5% (to above 1.17, a level some would have thought unthinkable two quarters ago) and our (previously bullish and out-of-consensus) forecasts appear outdated – if not outright bearish in the near term.

We believe that a number of developments these past couple of months suggest that the euro's convergence towards equilibrium has begun in earnest, no longer justifying a very cautious approach. Consequently, we raise our EUR-USD year-end target to 1.20 (1.14 previously) and end-2018 forecast to 1.25 (1.18 previously), which would bring the currency pair in line with its fundamentally assessed value. We see risks slightly skewed to the upside.

ECB: dovish but relaxed on FX

Since 2015, EUR-USD undervaluation has been partly induced by the ECB (with the strong dollar also playing its part). While the latest ECB press conference was generally dovish, Mario Draghi struck a rather relaxed tone on the appreciation of the exchange rate[1]. This is an important development for the FX market as it comes on the back of EUR-USD having risen by 11.5% YTD, outperforming almost all other major currencies against the dollar (see chart 1).

CHART 1:
EUR-USD OUTPERFORMING MAJOR FX AGAINST THE DOLLAR



Source: Bloomberg, UniCredit Research

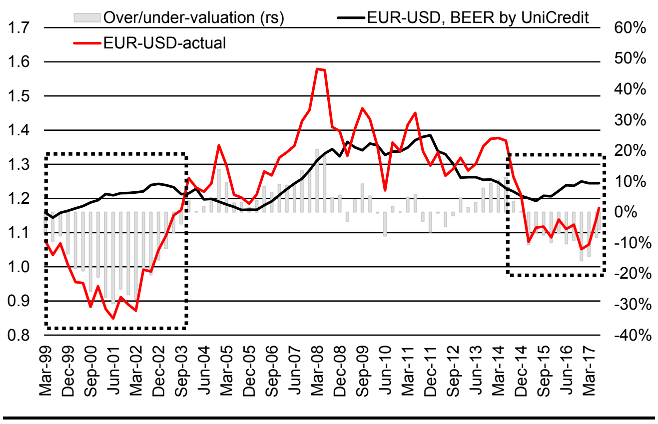
To clarify, this does not imply that the ECB has decided to turn its back on the FX market but it does suggest that the central bank's "pain threshold to euro upside" has risen (as a reaction to better economic fundamentals).

This is critical, particularly within the context of EUR-USD undervaluation, because it increases the likelihood of there being fewer obstacles on the convergence path to equilibrium. Consequently, the divergence looks set to close faster than even we (euro-bulls) initially thought.

[1] From ECB President Mario Draghi's Q&A on 20 July 2017: "…it's true there have been movements in bond prices, asset prices, exchange rates and so on. But the conclusion is that the financing conditions remain broadly supportive to secure a sustained return of inflation rates towards our inflation aim. Long-term yields have risen, but they still are low by historical standards. Sovereign spreads have tightened, and some issuers have seen even falling rates. The corporate bond spreads have continued to decline. The ten-year GDP weighted average of euro area sovereign yields stands close to its level at the beginning of the year. Bank lending rates continue to be at very supportive levels, and the Bank Lending Survey suggests that banks expect a further net easing of their credit standards across all loan categories in the third quarter. The repricing of the exchange rate has received some attention during the various exchanges of views, and in various ways. That's been something that, just as I said, has received some attention."

Of course, there is always the risk that the central bank will dial up its currency rhetoric but with economic dynamics in the eurozone having improved more than most expected (and the dispersion of growth rates amongst member economies in compression mode), it is difficult for the ECB to be "credibly too dovish" – unless a negative shock hits the region. And the market is now becoming all too aware of this.

CHART 2: EUR-USD VS. ESTIMATE OF EQUILIBRIUM VALUE



Source: Bloomberg, Haver, UniCredit Research

Typically, we estimate that it takes about two years for a currency to close half of a misalignment gap. But in instances in which the initial divergence is significant (in excess of 15%), convergence can be faster than that implied by historical adjustment coefficients. For example in 2000-02 when – by our estimates – EUR-USD remained significantly undervalued for nearly three years (in excess of 20%), the subsequent reversal to equilibrium (that started in late 2002) occurred at a very rapid pace: by mid-2003, EUR-USD had closed the undervaluation gap and by late-2003 had swung to overvalued levels (see chart 2).

Fast-forward to today and our estimates suggest that EUR-USD undervaluation stood at 16% at the end of last year. Within the space of two quarters, the currency has closed more than half of the gap – aided recently by ECB communications. Although it is unlikely that the speed of convergence will mimic that of 2003, the pace of the move these last few months together with the ECB further watering down its FX obsession suggest that equilibrium (1.25) will be reached at a faster clip than we had initially pencilled in.

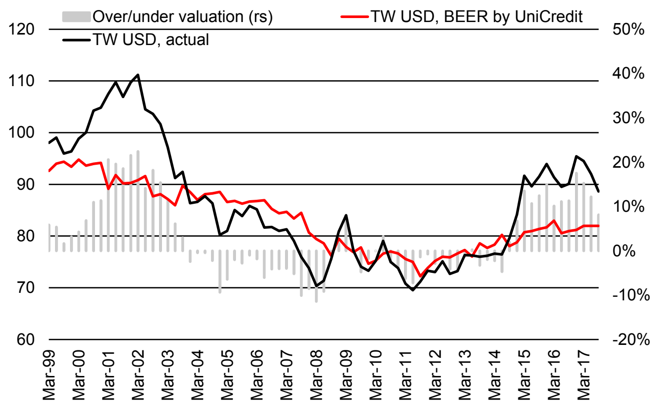
Aside from the "pure euro factor" there is an additional and – equally important – driver, in our view.

Dollar weakness everywhere

A crucial feature of this year's FX market developments is that the rise in EUR-USD does not simply reflect euro strength but also general USD weakness; after all, TW EUR is up 4.5% YTD, while the TW USD is down 8.5% over the same period. This is important for two reasons:

First, the direct impact is broad-based pressure on USD against all currencies (including the euro); and since this pressure is fundamentally rooted (we now see the TW USD as 8% overvalued[2] – see chart 3), it is very difficult to see how this process can stop or reverse – especially when the US administration keeps stumbling from one mess to the next.

CHART 3: TW USD STILL IN AN ADJUSTMENT PROCESS LOWER



Source: Bloomberg, UniCredit Research

Second, the broad-based dollar weakness mitigates some of the upside pressures on TW EUR, making the ECB's life a bit easier. In particular because USD has depreciated against GBP and CNY, EUR-GBP and EUR-CNY appreciation has been perceptibly lower than that of EUR-USD: EUR-GBP is up 4.5% and EUR-CNY 7.5% on a YTD basis.

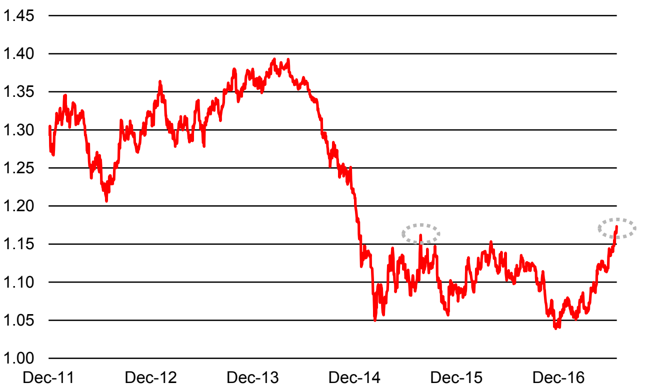
With EUR-CNY commanding the top spot (in weight terms) in the TW EUR index[3] (22%) and EUR-GBP ranking third (following EUR-USD, with a weight of 13%), moves in these crosses are very important for the TW exchange rate. Although we see further upside in both, the dollar's broad-based downward spiral is set to continue (see below for some additional changes to our USD forecasts), keeping the moves in check and allowing the ECB breathing space and a more relaxed stance.

[2] Note that USD overvaluation is not in contrast with our expectations of monetary policy normalisation in the US. It simply reflects our estimate that the dollar overshoot substantially fundamentals, including real rate differentials.
[3] Here we use EER-19

Momentum: growing stronger

Finally – from a technical perspective – EUR-USD is breaking above multi-year highs (see chart 4) while price momentum is growing stronger – both in the short term and in the more-medium term (see chart 5).

CHART 4: EUR-USD BREAKING OUT OF MULTI-YEAR HIGHS…

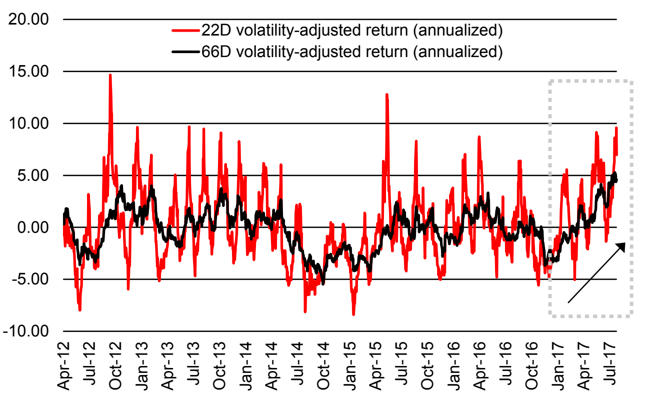


Source: Bloomberg, UniCredit Research

The confluence of supportive near and medium-term signals is bullish for the currency, especially in view of ongoing undervaluation.

Although the pace is likely to moderate (as positioning is stretched), in our view there is little or no reason for quant and macro players to abandon the theme of euro upside (absent an economic or political shock).

CHART 5: …AS MOMENTUM MEASURES GROW STRONGER



Source: Bloomberg, UniCredit Research

Stay EUR-USD long

In short, EUR-USD is in a sweet spot currently: still undervalued, with strong upside momentum, and positive economic and political dynamics in the euro area acting as tailwinds amidst a sustained USD-bearish market mood.

Our EUR-USD forecasts (alongside some additional USD forecast changes – see below) imply that the TW EUR is likely to appreciate another 2% from here to year-end and a further 2.5% in the course of 2018. Assuming our central scenario of ongoing economic strength in the euro zone, this is something that we think will be tolerated by the ECB and will not provoke verbal intervention and/or action.

In terms of risks to our view, we would say the following: EUR-USD renewed downside would require a combination of **1.** a change in USD sentiment (which would likely happen only if the Fed turned overly hawkish) and **2.** a euro-area negative shock that shakes investor confidence and "forces" the ECB to resume harsh FX rhetoric – though it must be pointed out that putting "its money where its mouth is" this time would be more difficult than in 2014 and 2015. Italian elections might also be a source of uncertainty. On the other hand, there are also risks to the upside, mainly because empirically the process of convergence to fair value rarely stops at equilibrium levels; more frequently than not, it tends to overshoot, partly because of market inertia. On balance, we think risks are slightly skewed to the latter.

Additional changes to some of our other forecasts

USD-CAD: a tad faster correction lower

We have long been CAD bulls on the basis of **1.** significant USD-CAD overvaluation (our estimate of fair value stands at 1.20) and **2.** the market having been too complacent about monetary policy expectations. But the tide has turned, with investors moving swiftly these past couple of months to re-price higher the interest rate path, as economic fundamentals have improved and the labour market is becoming tighter.

Consequently, and as oil prices turn (marginally) supportive we see USD-CAD converging to fair value at a slightly faster clip. We have pencilled in 1.24 for year-end (1.26 previously) and 1.20 for end-2018 (1.22 previously).

Revising the RMB path – stability over flexibility

Additionally, we revise our USD-CNY forecasts to 6.85 for end-2017 (7.00 previously) and to 7.00 for end-2018 (from 7.15 previously).

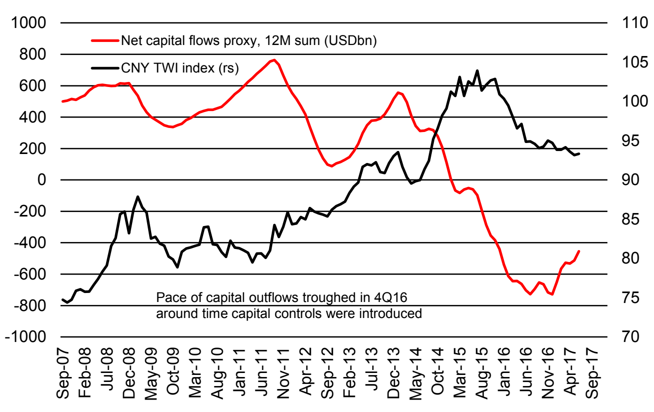
Back in January 2016, when we first began providing USD-CNY forecasts, we had a bearish view on the CNY, which played out for most of 2016 (See *FX Special* "CNY forecast revisions: PBoC's regime change argues for more weakness", January 2016).

This reflected an element of positive momentum in the USD, but was largely based on Chinese factors. As a reminder, our main thesis was based on the following assumptions: **1.** that the Chinese would continue to open the capital account as a matter of priority (given their goal of making the CNY a reserve currency); **2.** that China would see outflows of a "structural" nature, given pent-up desire to diversify large savings into foreign assets; and **3.** that the authorities would maintain easy monetary policy (relative to the Fed), given the "cyclical" weakness in the economy.

An open capital account and easier monetary policy implied that the CNY would have to weaken alongside the force of capital outflows, and drawing down on FX reserves (while large) was not seen as a sustainable option (See *FX Flash* "CNY: a forecast update", May 2016). This view played out through 2016, with the TW CNY weakening through the ups and downs of the broader USD trend. However, a number of things have since changed. First, the economy entered a cyclical rebound (helped by large fiscal stimulus) and growth is holding up much better. Second, and much more importantly in our view, since 3Q16 the Chinese have tightened capital controls (on outflows) significantly. In effect, this has completely reversed the previous policy goal of two-way opening of the capital account.

This has been a significant change and China's strategy has allowed for capital outflows to slow to a trickle, helping to keep the CNY relatively stable (see chart 6). We believe that the strategy of tightening capital controls is linked to a campaign to de-leverage the economy and, for this, keeping capital at home is essential (and as our recent *Sunday Wrap* argues).

CHART 6: NET CAPITAL FLOWS AND TW CNY



Source: Bloomberg, UniCredit Research

Assuming that authorities' policy priority is to continue to favour stability (over FX and capital-account reform), TW CNY should stay stable, in turn allowing USD-CNY to be increasingly driven by broader USD (and EUR-USD) movements.

Consequently, we lower our forecast profile for USD-CNY to 6.85 by year-end and 7.00 by end-2018. However, should the authorities at some point shift back to focusing on opening the capital account, then we think that depreciation pressures will likely return.

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UniCredit FX forecasts

EUR	Current	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	3M	6M	12M	BEER*	Deviation**
G10												
EUR-USD	1.17	1.18	1.20	1.20	1.22	1.23	1.25	1.19	1.20	1.22	1.25	-6.4%
EUR-CHF	1.12	1.11	1.12	1.12	1.12	1.13	1.14	1.11	1.12	1.12	1.21	-7.4%
EUR-GBP	0.89	0.91	0.92	0.92	0.94	0.94	0.95	0.92	0.92	0.94	0.76	17.1%
EUR-JPY	130	127	128	128	128	125	125	129	128	127	113	15.0%
EUR-NOK	9.28	8.90	8.70	8.50	8.30	8.20	8.10	8.83	8.63	8.27	7.54	23.1%
EUR-SEK	9.59	9.40	9.30	9.20	9.10	9.00	8.90	9.37	9.27	9.07	7.46	28.6%
EUR-AUD	1.46	1.44	1.43	1.43	1.45	1.45	1.47	1.43	1.43	1.45	1.79	-18.4%
EUR-NZD	1.55	1.57	1.58	1.56	1.58	1.58	1.60	1.59	1.58	1.58	1.81	-14.4%
EUR-CAD	1.46	1.48	1.49	1.49	1.50	1.50	1.50	1.49	1.49	1.50	1.50	-2.7%
EUR-TWI	98.6	99.5	101	101	102	102	103	99.9	101	102	n.a.	n.a.
CEEMEA & CHINA												
EUR-PLN	4.26	4.26	4.15	4.16	4.12	4.12	4.10	4.23	4.16	4.10	4.26	0.0%
EUR-HUF	305	308	312	312	313	310	313	310	310	310	357	-14.6%
EUR-CZK	26.1	26.4	26.5	26.4	26.3	26.1	26.0	26.4	26.4	26.2	32.0	-18.4%
EUR-RON	4.56	4.52	4.58	4.54	4.56	4.53	4.63	4.55	4.54	4.51	n.a.	n.a.
EUR-TRY	4.13	4.13	4.54	4.80	4.79	4.74	5.06	4.32	4.68	4.70	n.a.	n.a.
EUR-RUB	69.6	69.2	71.0	71.2	72.5	74.4	76.2	70.0	71.0	72.9	n.a.	n.a.
EUR-ZAR	15.1	15.9	16.3	16.0	15.9	15.5	15.5	16.1	16.2	15.7	n.a.	n.a.
EUR-CNY	7.89	8.02	8.22	8.28	8.45	8.55	8.75	8.12	8.24	8.47	n.a.	n.a.

USD	Current	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	3M	6M	12M	BEER*	Deviation**
G10												
EUR-USD	1.17	1.18	1.20	1.20	1.22	1.23	1.25	1.19	1.20	1.22	1.25	-6.4%
USD-CHF	0.96	0.94	0.93	0.93	0.92	0.92	0.91	0.93	0.93	0.92	0.97	-1.0%
GBP-USD	1.31	1.29	1.30	1.30	1.30	1.31	1.32	1.29	1.30	1.30	1.63	-19.6%
USD-JPY	111	108	107	107	105	102	100	108	107	104	90.9	22.1%
USD-NOK	7.93	7.54	7.25	7.08	6.80	6.67	6.48	7.42	7.19	6.78	6.04	31.3%
USD-SEK	8.19	7.97	7.75	7.67	7.46	7.32	7.12	7.87	7.73	7.43	5.98	37.0%
AUD-USD	0.80	0.82	0.84	0.84	0.84	0.85	0.85	0.83	0.84	0.84	0.70	14.3%
NZD-USD	0.75	0.75	0.76	0.77	0.77	0.78	0.78	0.75	0.76	0.77	0.69	8.7%
USD-CAD	1.24	1.25	1.24	1.24	1.23	1.22	1.20	1.25	1.24	1.23	1.20	3.3%
USTW$	88.6	87.6	86.5	86.5	85.3	84.1	82.8	87.2	86.5	84.9	82.1	7.9%
USD-DXY	93.6	92.9	91.6	91.5	90.2	89.2	87.8	92.5	91.6	89.9	n.a.	n.a.
CEEMEA & CHINA												
USD-PLN	3.64	3.61	3.46	3.47	3.38	3.35	3.28	3.55	3.47	3.36	3.42	6.4%
USD-HUF	261	261	260	260	257	252	250	261	258	254	286	-8.7%
USD-CZK	22.3	22.4	22.1	22.0	21.6	21.2	20.8	22.2	22.0	21.5	25.6	-12.9%
USD-RON	3.90	3.83	3.82	3.78	3.74	3.68	3.70	3.82	3.78	3.70	n.a.	n.a.
USD-TRY	3.53	3.50	3.78	4.00	3.92	3.85	4.05	3.63	3.90	3.85	n.a.	n.a.
USD-RUB	59.4	58.6	59.2	59.3	59.4	60.5	61.0	58.8	59.2	59.8	n.a.	n.a.
USD-ZAR	12.9	13.5	13.6	13.3	13.0	12.6	12.4	13.5	13.5	12.9	n.a.	n.a.
USD-CNY	6.74	6.80	6.85	6.90	6.93	6.95	7.00	6.82	6.87	6.94	n.a.	n.a.

Forecasts are end-of-quarter / end-of-month forecasts.

*BEER values are fair value estimates based on our Behavioural Equilibrium Exchange Rate model (see *UniCredit Global Themes Series* "Introducing BEER by UniCredit", 3 September 2013).
**Deviation between current value of the exchange rate and the fair value estimate

Source: Bloomberg, UniCredit Research

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