FX

Global

FX Flash

EUR: Weakness Likely to be Capped

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EURUSD Weakened About 2% Last Week

EURUSD weakened by about 2% last week, with most of the price action coming in post-US CPI (Wed, 10 Apr) and post-ECB hold (Thu, 11 Apr). The main driver for the recent bout of weakness is central bank divergence between the Fed, which now look less likely to cut, and the ECB, which now look more likely to cut earlier. US CPI came in hotter than expected which drove the narrative that the Fed are less likely to cut and could cut by less than initially expected as market is pricing in two 25bps cuts (prev: three 25bps cuts). Meanwhile, the ECB all but confirmed a cut in Jun, subject to their usual caveat of data dependence. Market pricing for a Jun ECB cut rose to 88% (prev: 77%) post-ECB decision. The EURUSD has currently stabilized at 1.0650 levels, below the previous key 1.0700 level and this suggests that further EUR weakness is likely as both fundamentals and technicals align for EUR weakness. We examine three scenarios for the Fed and ECB going forward.

Near-term EUR Downside Likely; Longer-term EUR Supported

Meanwhile, with the EUR making up about 58% of the DXY basket, the DXY trades above the key 106.00 level given the current weakness in the EUR. We believe that the USD strength may be capped given how quickly and how much the narratives have swung in favour of USD strength. As we have cautioned, we do believe that USD can remain stronger for longer, but maintained that USD is likely to gradually weaken alongside Fed rate cuts and fading US exceptionalism in the medium to longer term. Our US economist still sees the Fed cutting rates two to three times in 2024. Separately, narratives for the EUR have swung to what could be perceived as peak bearishness for the EUR, and as such current expected divergence between the Fed and ECB could already have peaked. We also still expect Eurozone growth to bottom in the quarters ahead and for this to provide support for the EUR. As such, we suggest that while near-term EUR weakness is likely, EUR weakness could also be capped and we look for certain key levels on the DXY such as 107.00 to cap USD strength. This would imply that while near-term EUR weakness is likely, EURUSD downside could be supported at 1.05 or 1.04 levels.

Maintain EURUSD Forecasts

While we recognize that there is a likely scenario for further EUR weakness, and we would like to highlight the risks that the ECB may cut before the Fed, we may have already reached or are nearing the peak divergence between the ECB and the Fed. We maintain our current forecasts for the EURUSD for the next four quarters on the belief that the USD will gradually fade alongside fading US exceptionalism as growth in the Eurozone bottoms and Fed rate cuts.

SEE PAGE 5 FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

EUR Weakened About 2% Last Week

EURUSD weakened by about 2% last week, with most of the price action coming in post-US CPI (Wed, 10 Apr) and post-ECB hold (Thu, 11 Apr) as the pair traded from as high as 1.0870 levels down to a low of 1.0623. The main driver for the recent bout of weakness is central bank divergence between the Fed, which now look less likely to cut, and the ECB, which now look more likely to cut earlier. US CPI came in hotter than expected at 0.4% MoM (headline and core; exp: 0.3%; prev: 0.4%), 3.5% YoY (headline; exp: 3.4%; prev: 3.2%) and 3.8% YoY (core; exp: 3.7%; prev: 3.8%) and this drove the narrative that the Fed are less likely to cut and could cut by less than initially expected as market is pricing in two cuts (prev: three 25bps cuts). Meanwhile, the ECB all but confirmed a cut in Jun, subject to their usual caveat of data dependence. Market pricing for a Jun ECB cut rose to 88% (prev: 77%) post-ECB decision. The EURUSD has currently stabilized at 1.0650 levels, below the previous key 1.0700 level and this suggests that further EUR weakness is likely as both fundamentals and technicals align for EUR weakness.

Three Scenarios for Fed and ECB

We lay out three scenarios for interactions between the Fed and ECB and suggest that while near-term EUR downside is likely, it is also probable that EUR can still gradually make gains against the USD in the longer-term. These scenarios are namely Fed and ECB cuts come in roughly at the same time, ECB cuts before the Fed and lastly Fed and ECB both delay rate cuts.

Scenario 1: Fed and ECB Cut Roughly at the Same Time

This scenario remains our base case. While the ECB has been forthcoming with its forward guidance on rate cuts and ECB officials have all but confirmed a Jun cut while emphasizing data dependence. The ECB still needs to find comfort from about two months' worth of data that inflation is approaching their target to cut rates. At this point, it could also be argued that we are at peak-dovishness for the ECB. Meanwhile for the Fed, we recognize that the market is pricing in about two 25bps cuts from three. However, our economist sees two to three 25bps cuts in 2024. Given that one data point can change the Fed narrative so drastically in favour of the USD, we suggest that future data points could also swing the narrative the other way round. A similar repricing of ECB rate cut expectations could also happen with two months' worth of data to come. At this point, we suggest that when and if the ECB cuts, a Fed cut may not be that far off and as such EUR weakness could be limited and for a short period of time.

Scenario 2: ECB Cuts before the Fed

The latest developments have certainly raised the risk of this scenario occurring. We recognize that there are strong arguments for this scenario given the disinflation in the Eurozone vs the still firm inflation in the US. Stagnant growth in the Eurozone vs healthy growth in the US. Lagarde has also confirmed that the ECB can indeed cut independently and cut before the Fed. However, we do think that there must be some non-zero amount of consideration on how much this could weigh on the EUR and the resulting impact on inflation in the Eurozone. Moreover, ECB rate cuts may not be as much as the market is expecting and may therefore not weigh on the EUR as much. Lastly, a rate cut by the ECB could provide a support for Eurozone growth and this could support the EUR. We have indeed seen prior evidence that ECB rate cuts may not weigh on the EUR as much as people expect. In particular, even in the case of divergence between the

ECB and Fed, we are sceptical of EURUSD at parity, which some are suggesting.

Scenario 3: Fed and ECB Both Delay Rate Cuts

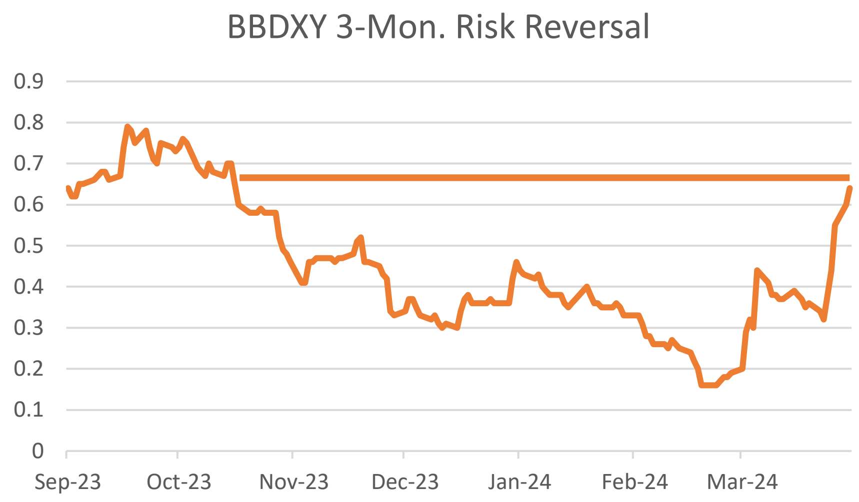
Ultimately, the comfort for both central banks in terms of when they can cut rates is derived from their certainty on disinflation, or how confident they are that inflation is on a downward trend to their target. This has been independently confirmed by both Fed Chair Powell and ECB President Lagarde. We think that there is a chance that upside risks to inflation play out and both central banks delay their rate cuts for longer than the market is expecting. We expect that the EURUSD would range-trade in such a situation. This also highlights that there should not be excessive EUR weakness in such a situation.

Near-term EUR Downside Likely; Longer-term EUR Supported

Meanwhile, with the EUR making up about 58% of the DXY basket, the DXY trades higher above the key 106.00 figure given the current weakness in the EUR. We believe that the USD strength may be capped given how quickly and how much the narratives have swung in favour of USD strength. As we have cautioned, we do believe that USD can remain stronger for longer, but maintained that USD is likely gradually weaken alongside Fed rate cuts and fading US exceptionalism in the longer term. Our US economist still sees the Fed cutting rates two to three times in 2024. Separately, narratives for the EUR have swung to what could be perceived as peak bearishness for the EUR, and as such current expected divergence between the Fed and ECB could already have peaked. The reality of what happens for central banks could swing in favour of EUR strength given how much hawkishness for the Fed and dovishness for the ECB has been priced in. We would also highlight that we still expect Eurozone growth to bottom in the quarters ahead and for this to provide support for the EUR. As such, we suggest that while near-term EUR weakness is likely, EUR weakness could also be capped and we look to see if certain key levels on the DXY such as 107.00 can cap USD strength. This would imply that while near-term EUR weakness is likely, EURUSD downside could be supported at 1.05 or 1.04 levels. There are risks that the DXY could surge and EUR could weaken beyond those levels, but such risks do not look likely.

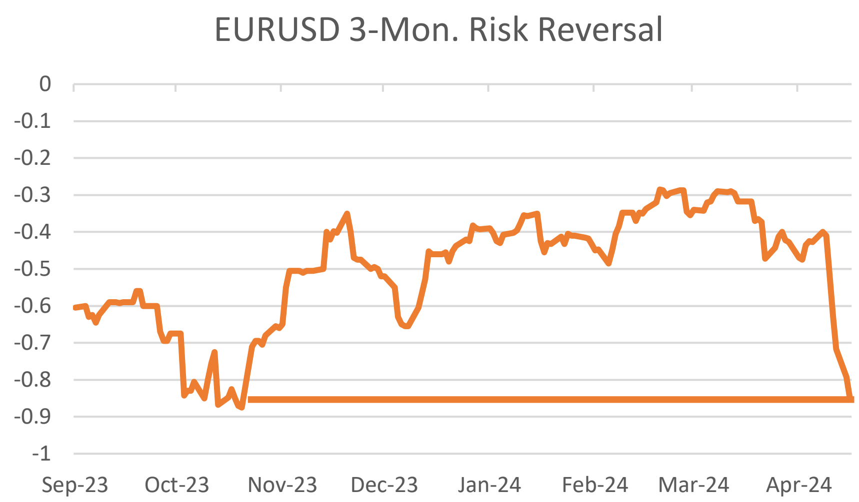
We can observe that there is evidence that USD risk reversals (which are a measure of difference in implied volatility between an out of the money (OTM) call and out of the money put) are at a five-month high (Chart 1). This means the implied volatility of similar calls is greater than the implied volatility of similar puts, which suggests that the market is positioned largely for a higher USD. Looking specifically at EURUSD risk reversals, we can discern a similar trend, or rather that the market is positioned largely for a weaker EUR (since base currency for EURUSD is EUR) and accordingly a stronger USD. This is supportive of our idea that we could be at peak bearishness for the EUR at this point, and could also suggest that we are at peak bullishness for the USD. The 3-month tenor for options is also especially interesting, with the ECB expected to cut rates in Jun and the Fed no longer expected to cut rates in Jun, this tenor covers central bank meetings of both the Fed and the ECB across the month of Jun. The themes from five months ago are also largely similar to current themes, and EURUSD indeed reversed a decline from 1.0450 lows in Oct to 1.1000 levels in late Dec. As such, we do have some conviction in our view that a reversal in USD strength is entirely possible, although we do recognize that this could take a longer timeframe to play out and short-term factors are still bearish for the EUR.

Chart 1: 3M BBDXY Risk-Reversal Premiums are at a 5-Month High



Source: Bloomberg, Maybank FX Research & Strategy

Chart 2: EURUSD Risk-Reversals are at a 5-Month Low



Source: Bloomberg, Maybank FX Research & Strategy

Maintain EURUSD Forecasts

While we recognize that there is a likely scenario for further EUR weakness, and we would like to highlight the risks that the ECB may cut before the Fed, we may have already reached or are nearing the peak divergence between the ECB and the Fed. We maintain our current forecasts for the EURUSD for the next four quarters on the belief that the USD will gradually fade alongside fading US exceptionalism as growth in the Eurozone bottoms and Fed rate cuts.

Table 1: EUR Forecasts

Forecast	2Q 2024	3Q 2024	4Q 2024	1Q 2025
EUR/USD	1.0800	1.0900	1.1000	1.1100
EUR/SGD	1.45	1.46	1.46	1.48
EUR/MYR	5.08	5.07	5.01	5.05

Source: Maybank FX Research & Strategy Estimates

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