Marketing Communication

NATIXIS INVESTMENT MANAGERS

Pulse

Global Market Strategy, NIM Solutions

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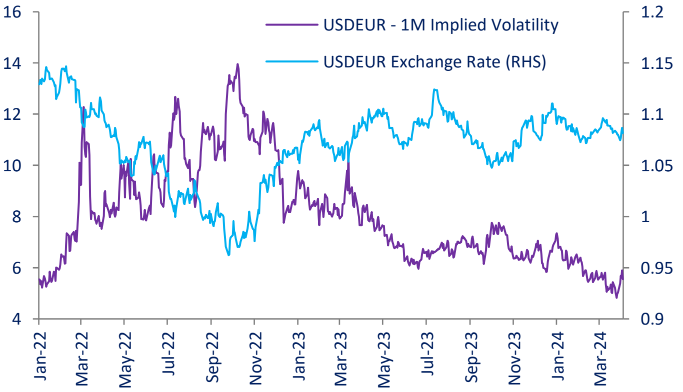
The US dollar mirrors its economy

The trajectory of the EURUSD pair mirrors multiple and often unstable balances. The growth differential, the trends in portfolio investment, the divergence in monetary policy, and the political developments are all parameters that need to be considered to assess the future dynamics of the currency pair. The EURUSD has been trading in a range between 1.05 and 1.11 since the beginning of 2023, but for how long more? And what would it take to see the pair breaking above or below these levels? We believe that both cyclical and structural reasons should lead the US dollar to appreciate against the euro over a period of 3 to 6 months and hence break below the of 1.05 level. Beyond that date, the euro should find its feet again thanks to the improvement in the European economic situation that we expect by 2025., and due to the stabilization of the monetary policy gap.

Cyclical and structural factors at play

The implied volatility of the EURUSD (extracted from options markets) is at historically low levels, a sign that investors do not perceive need to guard (hedge) against the risk of a sharp variation in the currency pair. However, any exogenous and anxiety-inducing event, like heightened political tensions, are likely to lead to an increase in this implied volatility, which should drive greenback higher. The Figure 1 below illustrating the negative relationship between equity implied volatility (an indicator of equity stress) and the euro dollar exchange rate validates the connection between these two variables.

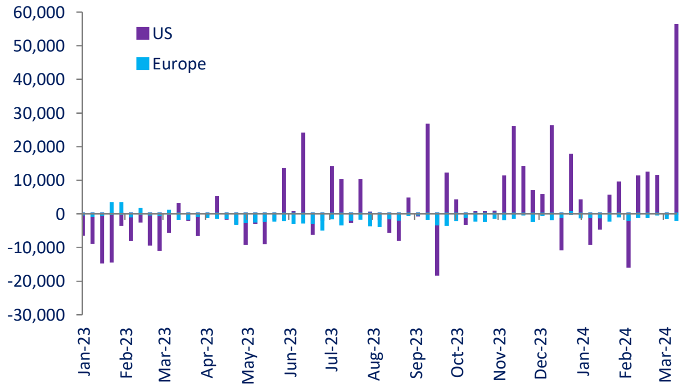
Figure 1: USDEUR Implied Volatility in %
(Sources: Bloomberg & NIM Solutions)



It is also worth noting that safe-haven assets such as gold or the Swiss franc (in real effective terms) have significantly appreciated in recent months, presumably in response to various tensions observed.

Moreover, the growth differential between the US and the Eurozone is a factor that should favour the US dollar in the medium term. In fact, the growth differential is expected to remain substantial in 2024, driven by both microeconomic and macroeconomic forces. GDP growth expected for 2024 ranges from 2.1% to 0.7% on both sides of the Atlantic. The same applies when considering the differential in corporate profit growth of the main companies that make up the major regional equity indices. Profits in 2024 are expected to increase by 10% for S&P500 companies and by 24% for Nasdaq companies, whereas the consensus projects only 4.5% profit growth for Stoxx600 companies. Such growth differentials should encourage investor inflows into the US, and thereby supporting the US dollar. In fact, US exchange traded funds (ETFs) have already been witnessing significant inflows since mid-2023 (see Figure 2).

Figure 2: US Equity ETFs Weekly Flows, Million USD
(Sources: Bank of America & NIM Solutions)



The US monetary policy stance is a mere response to an economy that has so far been unstoppable. After having priced in over 6 rate cuts for 2024, investors' expectations are now aligned with those of FOMC members, which expect 3 rate cuts during the year. These likely cuts could occur at the end of Q2 or the beginning of Q3. However, regardless of the Fed's timetable, investors believe that the ECB will need to be more proactive due to the challenges facing the Eurozone in terms of growth. The difference in the perception regarding the timing and extent of central banks' reactions is a short- and medium-term support factor for the US dollar, which should return to 1.05 within 3 to 6 months. However, this trend should come to an end by the end of the year and return to around 1.10, as the Eurozone economy rebounds in 2025.

Sources: Bloomberg & NIM Solutions. Data as of April 2, 2024.