FX Viewpoint

The EUR struggle: outlook for the rest of the year

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G10 FX Strategy
Global

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EUR outlook and drivers: weak vs. USD for now

The EUR is not weak, the USD is strong. Weak Eurozone data point to short-term EUR risks. Despite weak data, Eurozone inflation remains persistent. ECB monetary policy not tight enough to support the EUR. Eurozone fiscal policy not tight enough to help the ECB reduce inflation. Eurozone inflation expectations have increased. Real rate differentials would justify a weaker EURUSD. We stick to our end-year EURUSD forecast of 1.05, vs. a recently revised downward consensus of 1.10. Main risks have to do with timing and details of necessary landing.

Flows & positioning: EUR selling but Real Money still long

EUR flows have been negative this year, not only for investors and particularly Hedge Funds, but also for officials and corporates. Yet EUR positioning remains modestly long, driven by Real Money, who have only modestly pared back their EURUSD longs this year. This is the position around which we see risks going forward.

Quant: bearish EURUSD signals

Option flow shows notable shift from greater demand for EURUSD calls to puts around mid-May. More recently, positioning analysis also flagged the first bearish continuation signal for EURUSD in 2023. In addition to bearish EURUSD, fading EUR strength vs G10 high-betas is also worth considering from a quant perspective.

Vol: long-dated EUR vol show value at current level

After having bottomed out in first half of 2023, 1y EUR implied vols picked up quickly amid EUR spot-to-vol correlation turning negative. We still see value in owning long-dated EUR vols vs CAD, GBP, USD, NZD and AUD.

Technicals: EUR to struggle into year-end

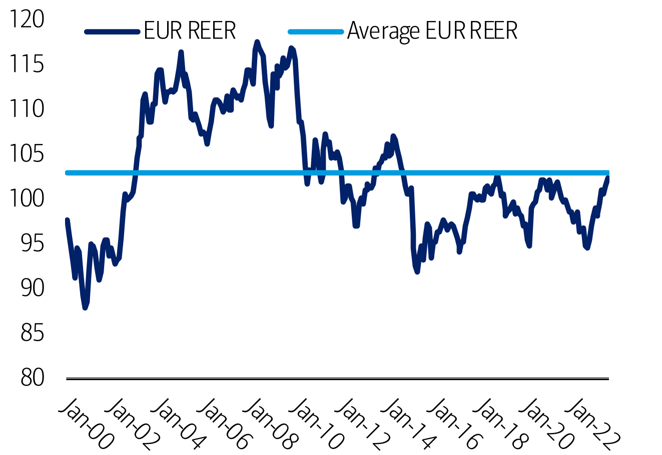
We see EUR sideways to lower into yearend. EUR uptrend since October 2022 bottom broke in August 2023. Sell rallies/fade resistance levels for decline to 1.0635 / 1.0516.

Refer to important disclosures on page 12 to 13.

EUR outlook and drivers: weak vs. USD for now

The EUR is not weak, the USD is strong. EURUSD is almost where it started the year, after having gone through a roller-coaster. EURUSD is stronger than last year, but most of this move took place by December. In real effective terms (REER), the EUR is at its historic average (Exhibit 1). In nominal effective terms (NEER), the EUR is historically strong (Exhibit 2)—the difference has to do with historically lower Eurozone inflation compared with its trading partners.

Exhibit 1: EUR Real Effective Exchange Rate (REER)
EUR Real Effective Exchange Rate (REER) back at historic average



Source: BIS

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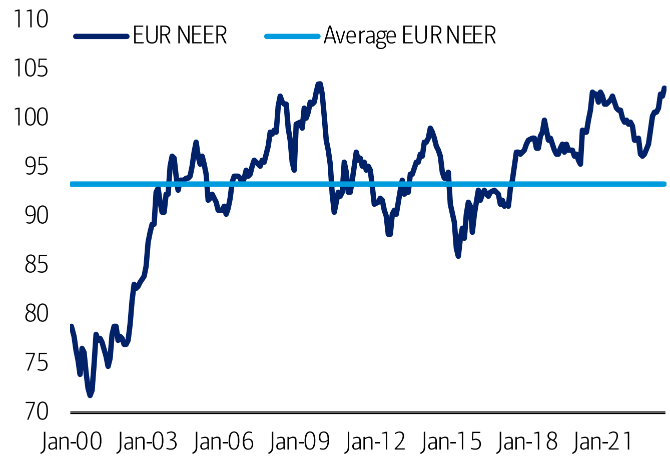
Exhibit 2: EUR Nominal Effective Exchange Rate (NEER)
EUR Nominal Effective Exchange Rate (NEER) historically strong



Source: BIS

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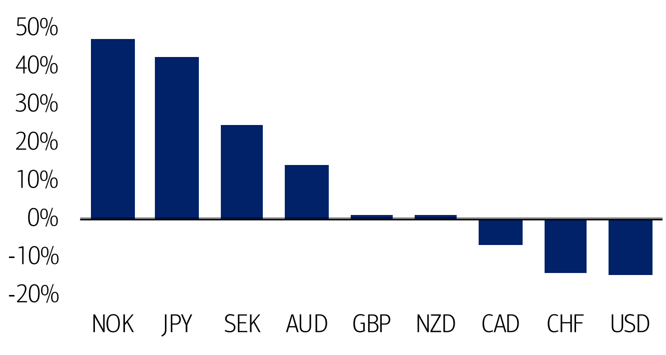
Indeed, equilibrium estimates confirm that the EUR is not weak across the board. Estimates from our BEER model suggest that the EUR is overvalued against NOK, JPY, SEK, AUD, undervalued against USD, CHF, CAD, and broadly at equilibrium against GBP and NZD (Exhibit 3). Against the USD, the EUR is undervalued by about 14% (Exhibit 4). (for details on methodology, please see [FX Viewpoint: Updating G10 FX equilibrium 20 April 2023](#)). To a large extent, EURUSD weakness has to do with USD strength.

Exhibit 3: EUR overvaluation estimates based on BEER model
EUR overvalued vs. NOK, JPY, SEK, AUD, undervalued vs. USD, CHF, CAD



Source: BofA Global Research

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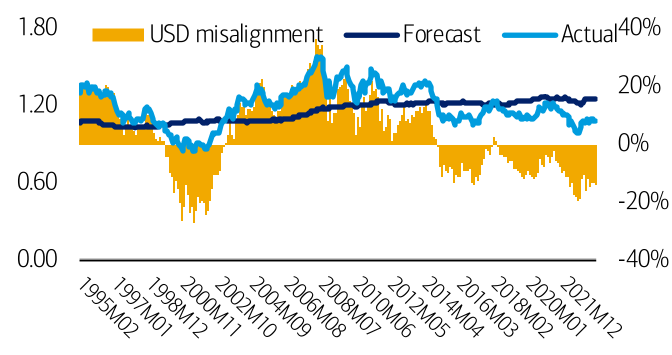
Exhibit 4: EURUSD misalignment estimates based on BEER model
EURUSD undervalued by about 14%



Source: BofA Global Research

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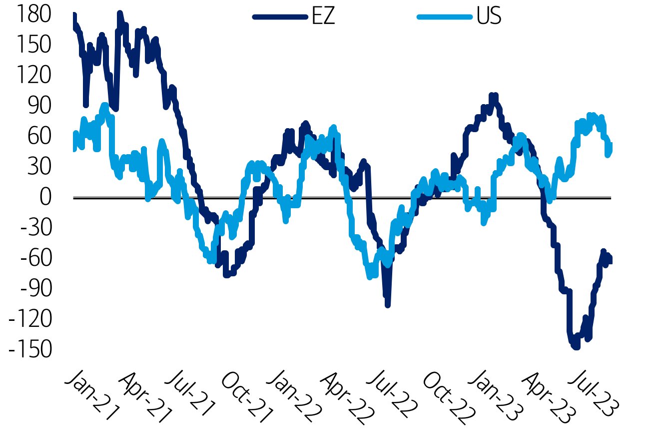
Weak Eurozone data point to short-term EUR risks. The Eurozone data has consistently surprised negatively in recent months, particularly compared with data in the US (Exhibit 5). PMIs point to weaker growth in both, but more so in the Eurozone (Exhibit 6). China's very weak recovery during the reopening could weigh on Eurozone data even more in the rest of the year. The recent increase in energy prices will cause a deterioration of the Eurozone's terms of trade, compared with an improvement earlier this year.

Exhibit 5: Data surprises
Eurozone data has been surprising negatively, particularly vs. the US



Source: Bloomberg, BofA Global Research

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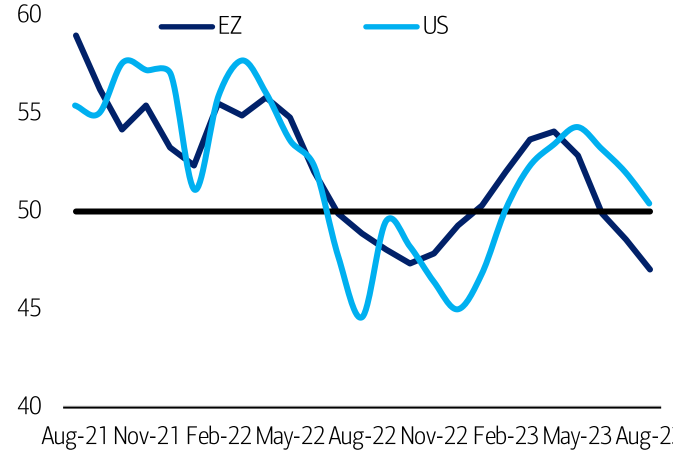
Exhibit 6: Composite PMI
Eurozone PMIs weaker than in the US



Source: Bloomberg, BofA Global Research

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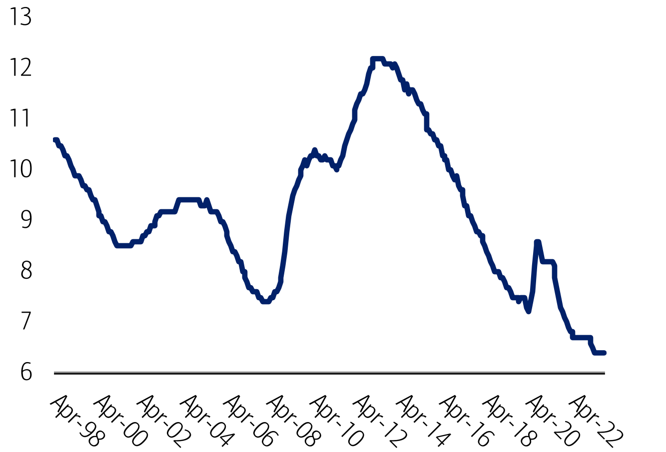
Despite weak data, Eurozone inflation remains persistent. The Eurozone labor market remains stretched, with the unemployment rate at an all-time-low (Exhibit 7). Headline inflation has dropped, but this is mainly because of the drop in energy prices earlier in the year, which is now reversing. Core inflation remains stuck well above 5% and higher than in the US (Exhibit 8).

Exhibit 7: Eurozone unemployment rate
Eurozone unemployment rate at an all-time low



Source: Bloomberg, BofA Global Research

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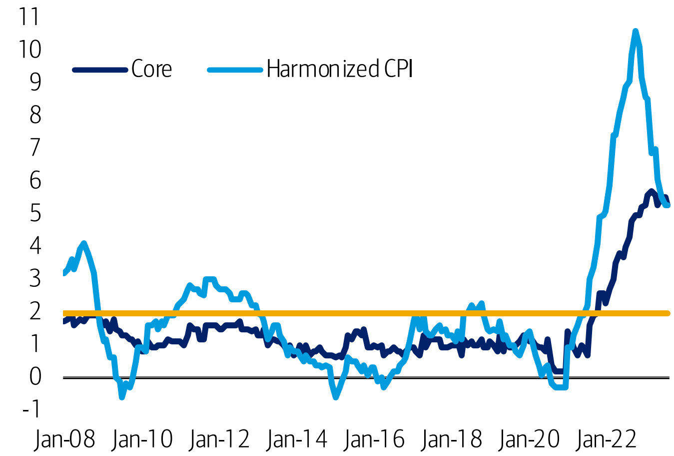
Exhibit 8: Eurozone inflation
Eurozone headline inflation has declined, but core inflation seems stuck



Source: Bloomberg, BofA Global Research

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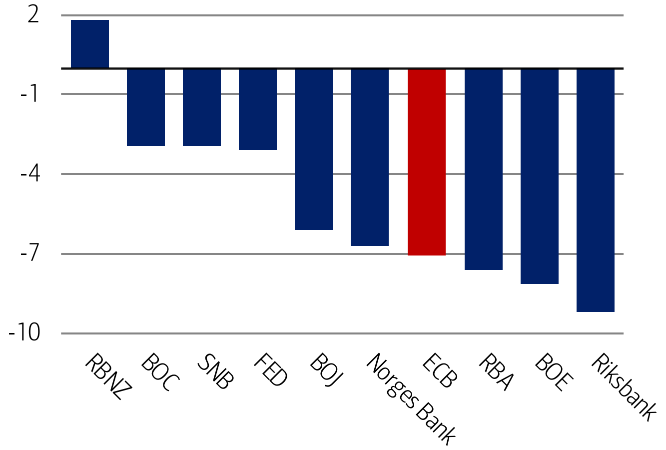
ECB monetary policy is not tight enough to support the EUR. Although the ECB has been more hawkish since last December, after being in denial for most of last year about persistent inflation risks and being the last G10 central bank except of the BoJ to stop QE and start hiking, it is hard to argue that they are doing more than other G10 central banks today. A Taylor rule spread suggests that the ECB monetary policy stance is not tight compared with the rest of G10, and particularly compared with that of the Fed (Exhibit 9). The same conclusion applies when we look at z-score Taylor spreads, which compares the monetary policy stance with its history for each G10 central bank (Exhibit 10). This is because of relatively high core inflation (which is what we use for the Taylor rule spread), historically low unemployment, and a policy rate that is still lower in the Eurozone than in a number of other G10 central banks, particularly that of the Fed.

Exhibit 9: Taylor rule spread
ECB monetary policy not tight vs. rest of G10 and particularly the Fed



Source: Bloomberg, BofA Global Research

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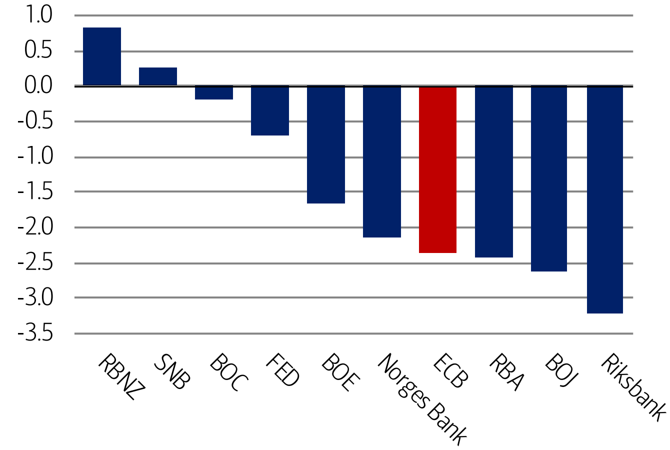
Exhibit 10: Taylor rule spread z-score
ECB monetary policy not tight vs. rest of G10 or its own history, and particularly vs. the Fed



Source: Bloomberg, BofA Global Research

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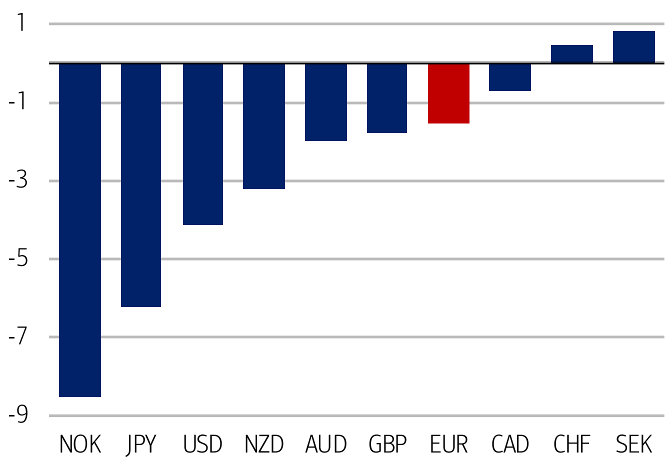
Eurozone fiscal policy is not tight enough in terms of what may be necessary to help the ECB reduce inflation. To be fair, fiscal policy is much looser in most other G10 economies and particularly in the US, based on the structural primary balance—primary balance adjusting for the cycle, as a share of potential GDP (Exhibit 11). However, this does not mean that Eurozone fiscal policy is appropriate given high and persistent inflation. Indeed, the Eurozone structural primary deficit is historically high (Exhibit 12). According to this measure, the Eurozone fiscal policy stance was too tight in the years after the global financial crisis and during the Eurozone crisis, which was an obvious and severe policy mistake. It was loose during the pandemic, which was clearly necessary to support the economy during the rolling lockdowns. However, it now remains loose, despite the recovery during the reopening, the drop in energy prices this year and persistent inflation. Looking forward, a lot depends on the reintroduction and reform of the EU fiscal rules, which however remains uncertain. For now, loose fiscal policy seems to be doing the ECB's job more difficult.

Exhibit 11: G10 primary structural balance, 2023
Eurozone fiscal policy not as loose as in some others in G10, but still loose



Source: IMF

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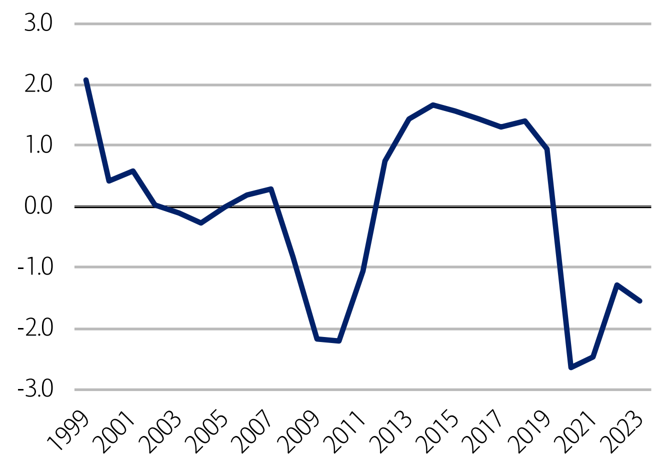
Exhibit 12: Eurozone primary structural balance
Eurozone fiscal policy historically loose



Source: IMF

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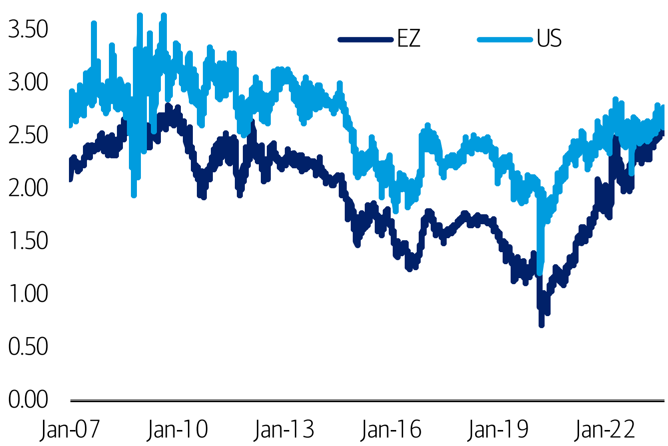
Eurozone inflation expectations have increased. Market pricing based on 5y5y inflation swap rates suggests inflation expectations are at historically high levels (Exhibit 13). For the first time, they are equal to that in the US. The market does not seem to expect the ECB to reach/stick to its inflation target.

Exhibit 13: 5y5y inflation swap rate
Eurozone long-term inflation expectations at historic high



Source: Bloomberg, BofA Global Research

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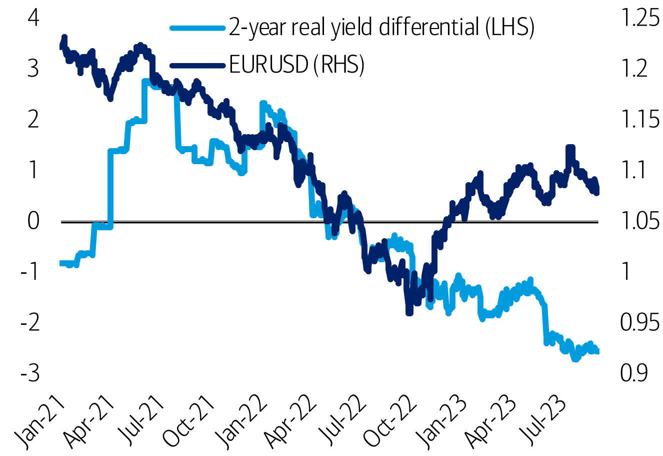
Exhibit 14: EURUSD and real yield differentials
Real yield differentials negative for EURUSD



Source: Bloomberg, BofA Global Research. Note: Real yields using latest core inflation rate.

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Following the faster drop in US inflation, real rate differentials would justify a weaker EURUSD (Exhibit 14). Earlier in the year, higher inflation was supporting the EUR, as the ECB was still catching up. Now that both the ECB and the Fed are almost at their terminal rates—we expect one last hike from each by the end of the year—the market has shifted to pricing a higher probability for a hard(er) landing when inflation is sticky, weighing on the currency. If both central banks stick to their inflation target, which we assume they will, stickier Eurozone inflation needs a weaker economy to come down, which in turn is negative for the EUR. Indeed, compared with the US, the Eurozone seems on a path for a harder landing. This also points to a lower r* (neutral rate of interest) in the Eurozone than in the US.

We stick to our end-year EURUSD forecast of 1.05, vs. a consensus of 1.10—we note that the consensus forecast has been revised down from 1.15 earlier this year. Although we expect EURUSD to eventually weaken, from our forecast of 1.05 this year to 1.15 next year and to the historic average and equilibrium estimate of 1.20 in 2025, this is mainly because we expect the USD to eventually weaken across the board, back to its long-term equilibrium. It is hard to argue for overall EUR strength based on where the EUR stands compared with most of the rest of G10—it is not weak--and the weak Eurozone data.

The main risk has to do with timing. Our key thesis remains. We need some landing of the economy, meaning higher unemployment, to get inflation all the way down, close to the target, in G10 economies. The timing and details of such landing compared with the rest of G10 are key risks for the EUR path forward.

Flows & positioning: EUR selling but Real Money still long

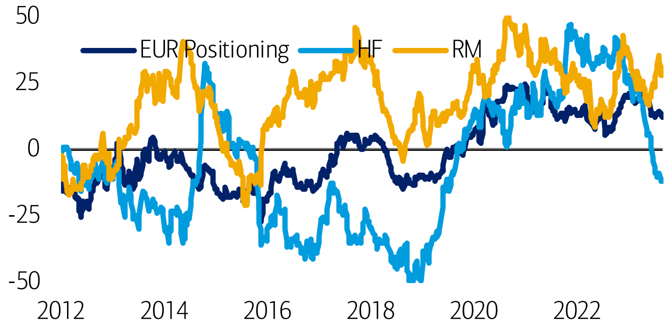
EUR positioning is modestly long and the second longest in G10 (Exhibit 15, Exhibit 16), according to our estimates. This is driven by Real Money, both according to our own data and the TFF (Traders in Financial Futures) report data for asset managers.

But investors—particularly Hedge Funds—have been selling the EUR this year, turning short EUR (Exhibit 17-Exhibit 19), with official and corporate flows also negative overall (Exhibit 20). Hedge Funds have sold the EUR mostly vs. GBP, USD, Scandies, and CAD. Real Money have somewhat pared back their EURGBP shorts and have also favoured JPY—but not the USD.

The bottom line is we see risks around the Real Money EURUSD longs given the much stronger US data and our disagreement with the pace of rate cuts priced for the Fed next year, both in absolute terms and relative to the ECB.

Exhibit 15: EUR positioning

EUR positioning modestly long, driven by Real Money. Hedge Funds short



Source: BofA Securities, Bloomberg. Note: +50 (-50) represents a max long (short) positioning level relative to Jan-2012. Aggregate positioning for G10 currencies takes into BofA Securities proprietary FX flows data as well as CFTC and BofA Global Research FX & Rates Sentiment Survey data. For details, please see Liquid Cross Border Flows: new look, same content 26 May 2021.

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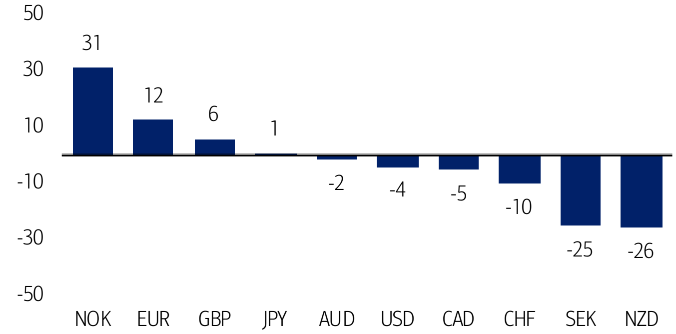
Exhibit 16: Latest aggregate G10 FX positioning

EUR positioning second longest in G10 but very modest



Source: BofA Securities, Bloomberg. Note: +50 (-50) represents a max long (short) positioning level relative to early 2012. Aggregate positioning for G10 currencies takes into BofA Securities proprietary FX flows data as well as CFTC and BofA Global Research FX & Rates Sentiment Survey data. For details, please see [Liquid Cross Border Flows: new look, same content 26 May 2021](#)

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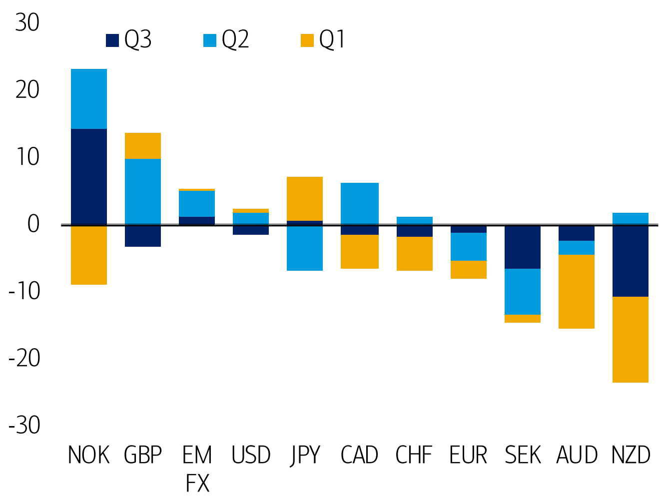
Exhibit 17: Aggregate positioning changes by quarter this year

EUR flows negative throughout 2023…



Source: BofA Securities, Bloomberg. We show changes in aggregate positioning by quarter. Currencies ranked on their year-to-date positioning change. For details, please see Liquid Cross Border Flows: new look, same content 26 May 2021.

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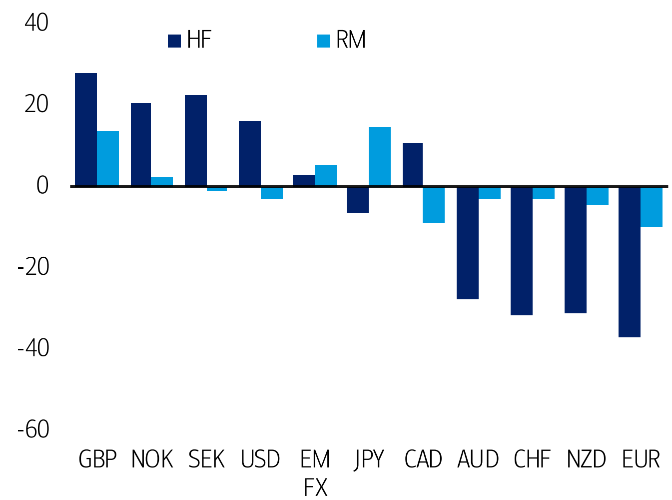
Exhibit 18: Positioning changes by BofA investor type this year

…with this true both for Real Money and, especially, Hedge Funds



Source: BofA Securities. We show changes in aggregate positioning by quarter. Currencies ranked on the BofA investor year-to-date positioning change. For details, please see Liquid Cross Border Flows: new look, same content 26 May 2021.

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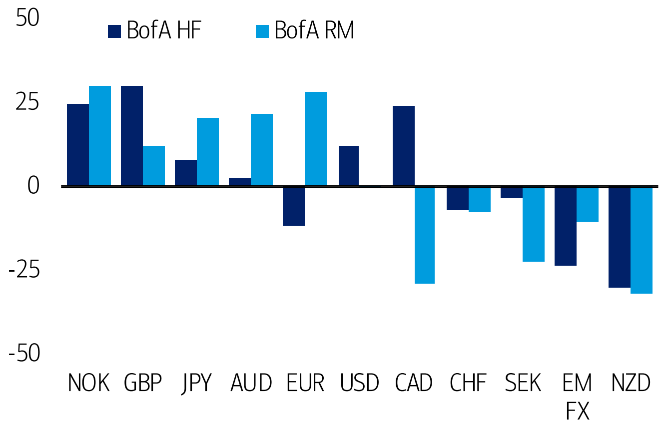
Exhibit 19: Latest BofA investor FX positioning levels
We see risks around the Real Money's EURUSD longs going forward



Source: BofA Securities. Note: +50 (-50) represents a max long (short) positioning level relative to early 2012. For details, please see Liquid Cross Border Flows: new look, same content 26 May 2021.

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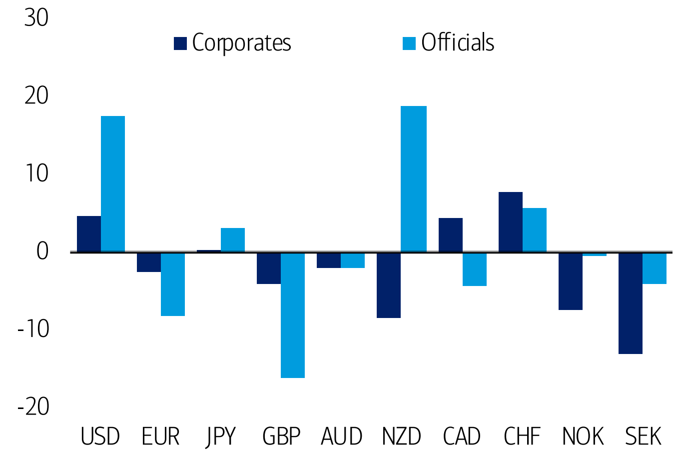
Exhibit 20: BofA corporate and official FX flows year-to-date (z-scores)
Corporate and official EUR flows have been negative year-to-date



Source: BofA Securities. We sum the weekly (2-year) z-scores by currency and client type. For details, please see Liquid Cross Border Flows: new look, same content 26 May 2021.

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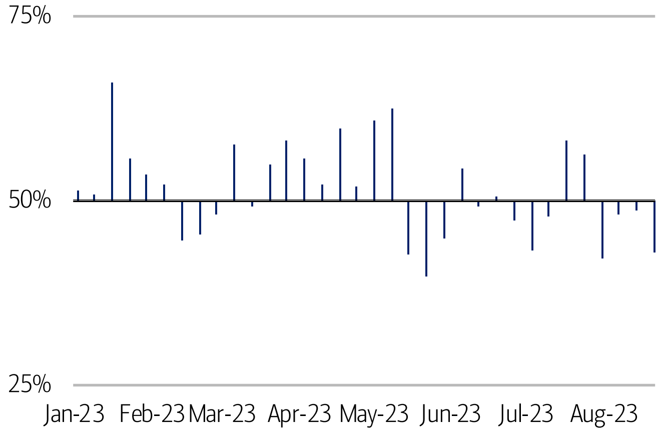
Quant: bullish EUR sentiment is fading

EUR positioning turn notably bearish for the first time in 2023

While the EUR had been one of the top performing currencies in G10 for most of this year, the bullish sentiment has petered out. From January to first week of May, weekly SDR option flow showed more demand for EURUSD calls than puts in 15 out of 19 weeks (Exhibit 21). Since then, the weekly call percentage ratio has skewed to below 50% (more demand for puts than calls) in 11 of the 15 weeks.

With EURUSD recently declining back to a 1.08-handle, the pair entered a downtrend, according to MAA (moving average aggregate). Our positioning analysis shows bearish EURUSD signal for the first time in 2023 (Exhibit 22), as both up/down vol (UD) and residual put skew (RS) indicators rose to above 50th percentile while downtrend formed for spot. Higher realized volatility to the downside and rising put skew vs spot depreciation suggest more short-term weakness for the EUR.

Exhibit 21: SDR flow shows more demand for EURUSD put started to emerge after May 2023
Weekly EURUSD call percentage ratio



Source: BofA Global Research, Bloomberg. DTCC.

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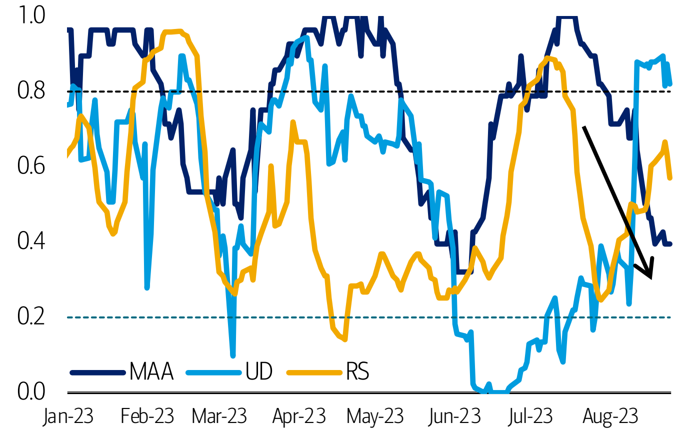
Exhibit 22: For the first time in 2023, positioning turns bearish for EURUSD with MAA below 50, up/down vol and residual skew above 50th percentiles
EUR/USD positioning analysis



Source: BofA Global Research, Bloomberg

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Also consider fading EUR strength vs the high-beta currencies in G10

Even more notable than the gain for EURUSD, the EUR trade-weighted index has reached its highest level since 1999 (Exhibit 23). Beyond EURUSD, the EUR has also made sizable gains vs AUD, NZD, and NOK this year. The combination of US recession concerns and weak economic data in China had weighed on these high-beta currencies. But with our US economists raising US growth outlook out of a mild recession (US Economic Viewpoint: 02 August 2023) and CNY already weakening close to our current peak USD/CNY forecast (Asia FI & FX Strategy Watch: 24 August 2023), investors could also consider fading EUR strength vs these G10 high-beta peers, in our view.

Exhibit 23: EUR TWI reached the highest level since 1999
EUR trade-weighted index

Source: BofA Global Research, Bloomberg

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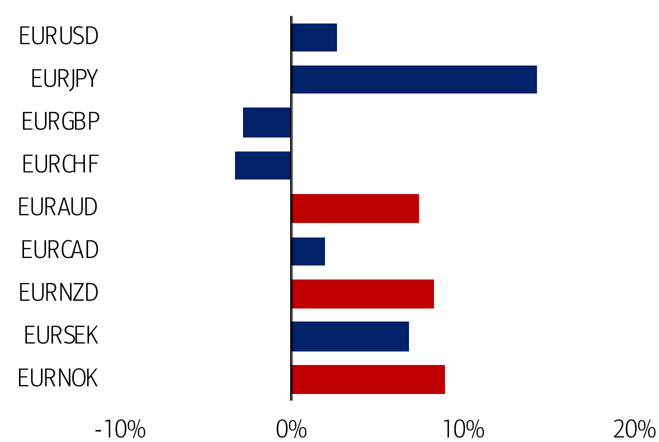
Exhibit 24: Investors could consider fading EUR strength vs G10 high-betas
EUR/G10 year-to-date returns



Source: BofA Global Research, Bloomberg

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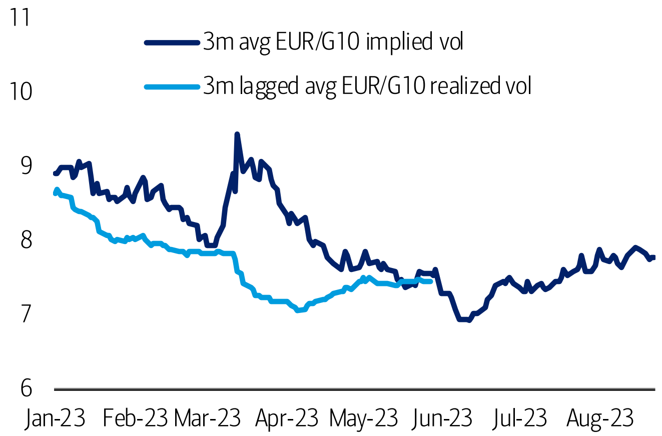
Vol: increased demand for long-dated EUR vol

EUR vols found bottom after underperforming in first half of 2023

In the first half of 2023, realized vols for EUR/G10 pairs have largely underperformed implied vols (Exhibit 25). As a result, EUR implied vols broadly declined but have started to pick-up after June. The rise of EUR implied vols at the 1y tenor is particularly notable, as the 2m change averaging +0.42 vols across EUR/G10 pairs would rank at 79th percentile over the past decade (Exhibit 26).

Exhibit 25: EUR realized vol has largely underperformed implied in 2023
3m avg implied and lagged realized EUR/G10 vols



Source: BofA Global Research, Bloomberg

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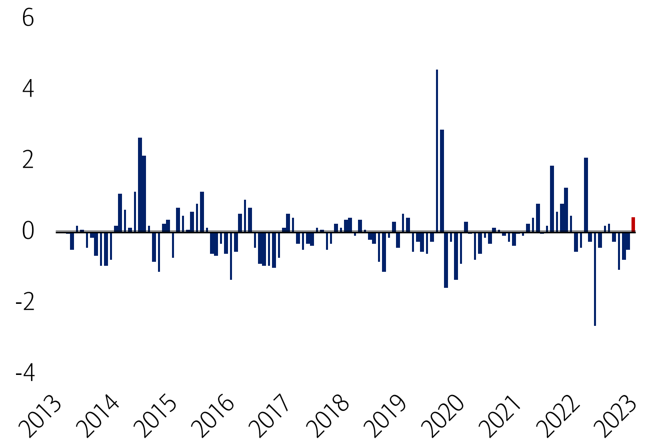
Exhibit 26: 1y EUR implied vol saw decent pick up since it bottomed in mid-June
2m change of avg 1y EUR/G10 implied vols



Source: BofA Global Research, Bloomberg

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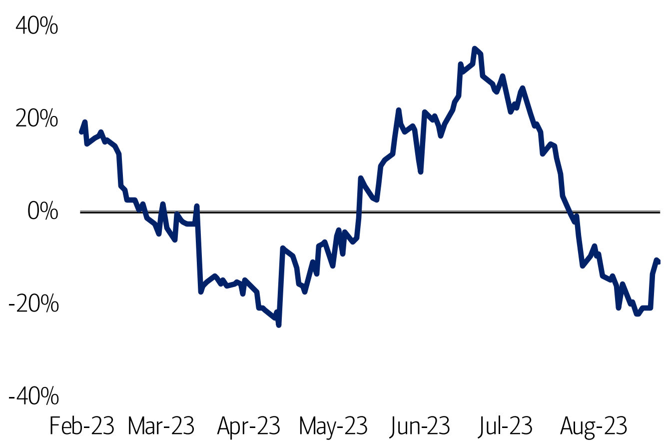
1y implied still worth owning for EUR vs USD, GBP, and liquid G10 high betas

The bottom for EUR implied vols this year coincided with the turn in spot-to-vol correlation. Average EUR/G10 1m spot-to-vol correlations have started to reverse lower since June and is now below 0. The negative spot-to-vol correlation suggests further EUR selloff would be accompanied by higher volatility. Across EUR/G10 pairs, current level of 1y implied vols are still at low percentiles vs long-term realized vol ranges for EUR vs CAD, GBP, USD, NZD and AUD (Exhibit 28). So, owning long-dated EUR vega in these pairs at current level would hedge against further EUR depreciation, in our view.

Exhibit 27: Spot-to-vol correlation has turned negative or EUR
Avg EUR/G10 spot-to-vol correlation



Source: BofA Global Research, Bloomberg

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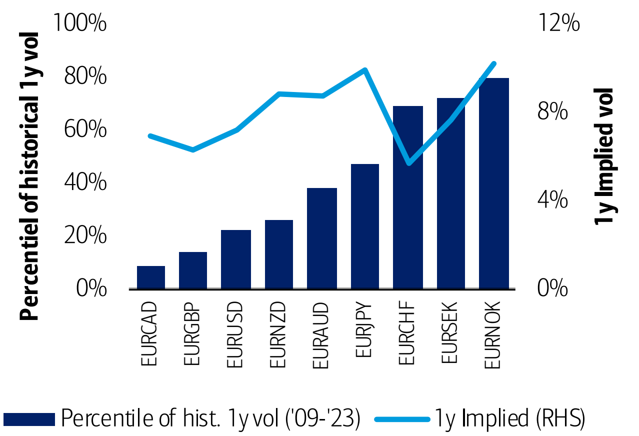
Exhibit 28: 1y EURCAD, EURGBP, and EURUSD implied vols stand out as the cheapest relative to historical range of realized vols
Current levels of 1y EUR/G10 implied vols and percentile to historical range of 1y realized vols



Source: BofA Global Research, Bloomberg

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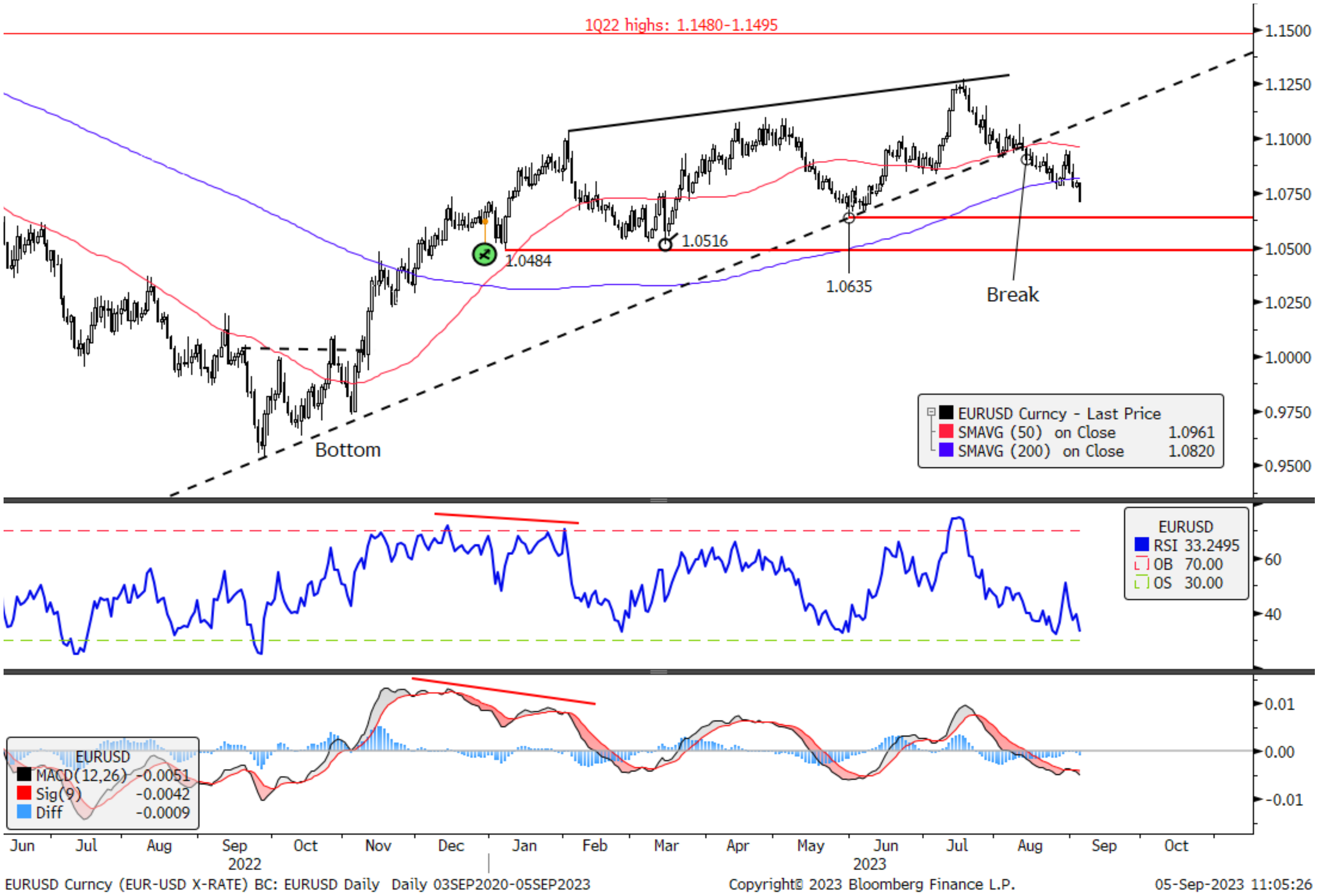
Technicals: Euro to struggle into year-end

Euro short term: Uptrend broke on Aug 15, sell rallies for year end downside

The uptrend in euro beginning from the bottom in Oct-2022 broke in August 2023. This means the uptrend has turned sideways or lower. We favor lower euro by selling rallies for a decline to the low end of YTD range of 1.0635 / 1.0516 / 1.0484.

Chart 1: EURUSD Daily chart

Uptrend from Oct 2022 base ended in August 2023. Sell a rally for end of year retracement lower to, for example, 1.0635, 1.0516 and 1.0484.



Source: BofA Global Research, Bloomberg

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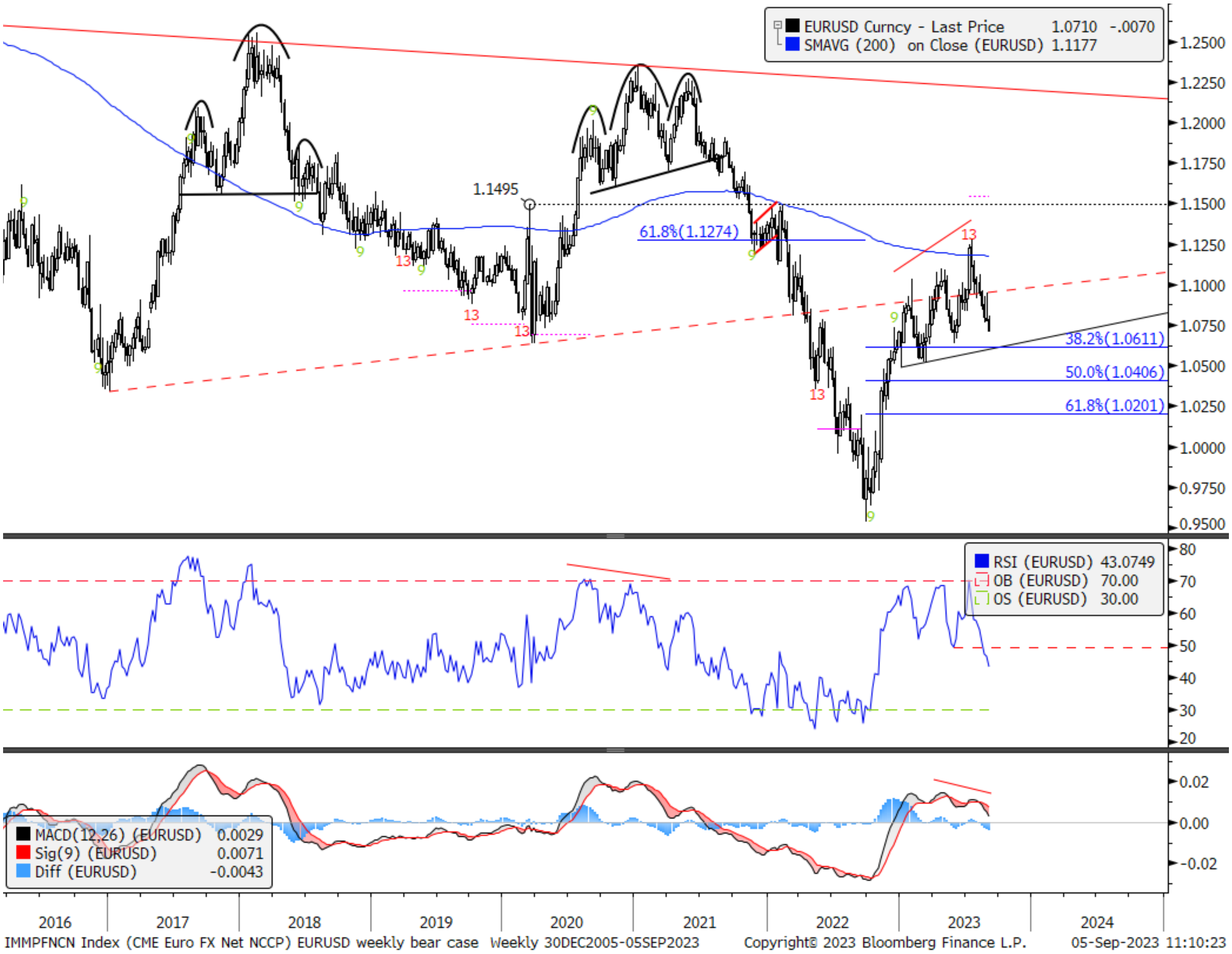
Euro medium term: Downside risk greater while < 200wk SMA

Spot euro remains below the 200wk moving average which from the bigger picture is one bearish trend condition that remains. A timely systematic TD Sequential sell signal had occurred when euro was at the YTD highs (13). Price action has confirmed it by declining. Weekly RSI (momentum) has broken to a new YTD low and MACD is declining. Use rallies to sell as trend turns sideways or lower into year end. The risk is a deeper Fibonacci retracement such as the 50% level at 1.0406 and/or the 61.8% level at 1.0201.

Euro support: 1.0635, 1.0516, 1.0484, 1.0406, 1.0201
Euro resistance: 1.0966, 1.1065, 1.1150, 1.1274, 1.1480

Chart 2: EURUSD Weekly

Use rallies to sell as trend turns sideways to lower into yearend 2023.



Source: BofA Global Research, Bloomberg

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