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Liquid Insight

Diving into the EUR/USD rebound

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Rates and Currencies Research
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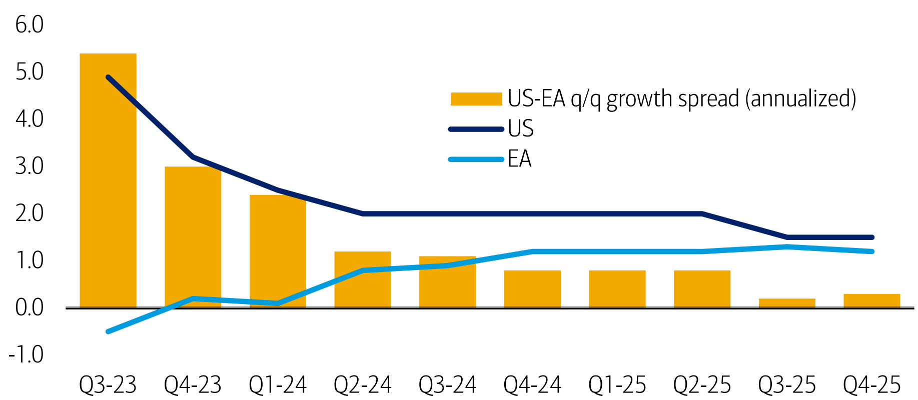
Key takeaways

- EUR/USD has rallied in recent weeks amid nascent signs of growth convergence and a more hawkish ECB than Fed
- Inf trending down in both, but services is sticky. US reacceleration risks are receding while wage concerns in the EA remain
- We expect the Fed and ECB to cut in June but neither is assured. Fed cuts mean more for FX, leading to our bearish USD f'cst

By Alex Cohen & Michalis Rousakis

Chart of the Day: BofA growth forecasts: US vs. Euro Area
US and Euro Area growth to converge through 2025



Source: BofA Global Research

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Setting up for a rally

The EUR has been among the top performing currencies amidst the USD's multi-week selloff. Despite hot January data in the US, more recent readings point to an early trend in the US/euro area growth convergence that we see as a theme over the course of the year. Steady dis-inflation continues on both sides of the pond, and neither has a monopoly on sticky services. Meanwhile, the Fed seems eager to get going with rate cuts, while the ECB appears patient for now. Both are expected to start cutting in June, and as we've argued previously, Fed cuts should matter more for FX and broader markets. That said, risks abound and market narratives can shift with the wind. Here we dive a bit deeper into these themes that have fit with both the EUR's recent rally and our Year end forecast of 1.15.

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It has been an action packed few weeks in FX, on both the USD and EUR side of the coin. Not long ago, the EURUSD pair touched on 3-month lows, driven by upside US January economic data, unexpected pushback on near-term cut expectations by the Fed, amidst lingering growth concerns and anticipated ECB dovishness.

More recently, these narratives are showing some nascent signs of converging. Recent US data readings have struggled to outperform expectations at the same pace as earlier in the quarter, while euro area data is starting to outperform more downbeat expectations. On the central bank side, both appear to be converging on June for the first cut of the cycle, though this is far from assured. Indeed, the pushing back of Fed cuts beyond June remains a considerable risk, and one that could remerge with just one big data print. Nevertheless, our outlook for the two regions, and similarly for the EURUSD pair, remains one of eventual "recoupling". converging gradually into 2025. (Chart of the Day). This should pave the way for a move towards FX equilibrium. Here we look deeper at some of these key factors for the EURUSD pair, as we head into the second quarter.

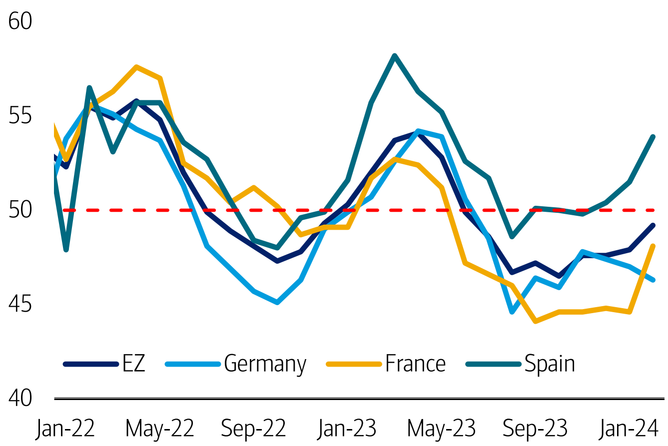
Growth: Early signs of US/EA convergence

With hot January readings of US inflation and employment in the rearview mirror, the US data flow has been somewhat quietly trending down over recent weeks. Most notably. the US employment report for February, while beating on the headline NFP, reflected notable downward payroll revisions and downside wage prints amidst an uptick in unemployment. ([US Watch: February US employment: Resilience, but not overheating 08 March 2024]) Elsewhere, durable goods, ISM manufacturing and ISM services for February all missed expectations on balance, and retail sales showed and unexpected decline from January.

Meanwhile, in the euro area, broad measures of activity have painted a somewhat mixed picture, as ongoing softness in Germany has been off set to a degree by signs of bottoming elsewhere in the core and periphery. This can be observed, for example, in euro area composite PMIs. (Exhibit 2) As a result, relative surprise indices between the US and euro area have continued to trend in the euro's favor, corresponding with the recent rise in the currency pair. (Exhibit 3)

Exhibit 1: Select euro area composite PMIs

Despite softness in Germany, euro area PMIs trending higher



Source: Bloomberg; BofA Global Research

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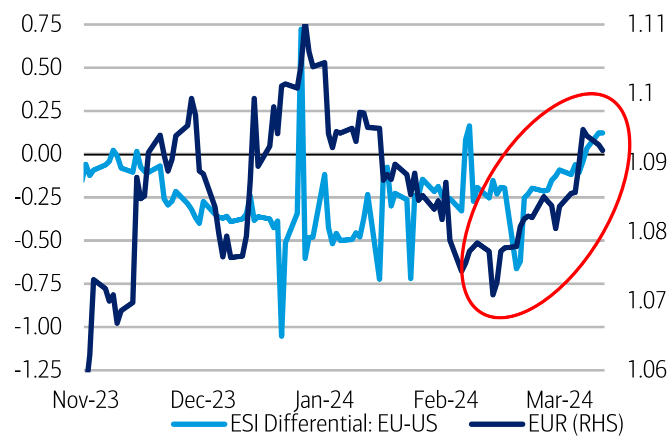
Exhibit 2: Bloomberg Economic Surprise Indices (ESI)

Relative surprise indices trending in EUR's favor over recent weeks



Source: Bloomberg; BofA Global Research

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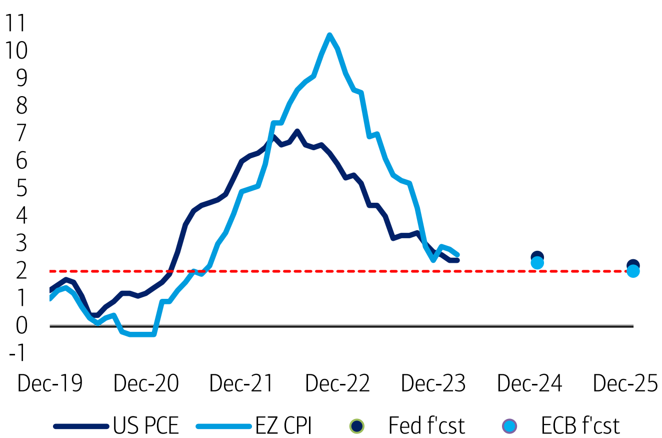
Inflation: Approaching target, but services remain sticky

On the inflation front, as we noted in [FX Viewpoint: USD: Bulls versus Bears 29 February 2024], there are several ways to interpret recent US data to support one's established views. This week's highly anticipated CPI report similarly sent mixed signals to the market, as goods prices ticked higher and core services ex-housing declined from last month yet remains elevated overall. (US Watch: February CPI Inflation: Services inflation softens, but goods surprise to the upside 12 March 2024) On balance, this latest reading is unlikely to overly sway the Fed in either direction, as some signs of stickiness can be counterbalanced to a degree by receding concerns of reacceleration.

Inflation readings in the euro area, meanwhile, have been improving overall but particular components less convincingly so, keeping the ECB very cautious. (Exhibit 4) That said, the ECB still views inflation dynamics as much stickier than our economists do. (Euro Area Watch: ECB review: June it is 07 March 2024) In any case, fears over a stagflationary outcome in the euro area have receded, consistent with the sharper downturn in euro area HICP, which was a factor that had led to added risk premia in the euro through much of last year.

Putting these together, key measures that these central banks forecast (PCE for the Fed, HICP for the ECB) are trending close to 2 percent, with both conveying guidance that they intend to cut rates well before such an outcome is reached. (Exhibit 5)

Exhibit 3: US and EA inflation & CB Forecasts
Key Fed & ECB headline inflation measures approaching 2%...



Source: Bloomberg; BofA Global Research

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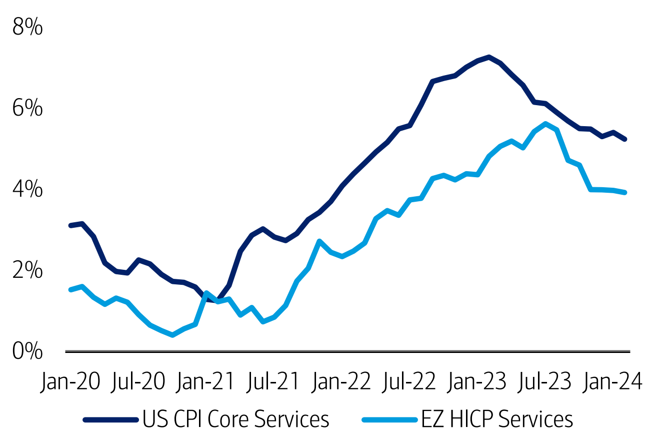
Exhibit 4: Euro Zone and US services inflation
... but services inflation remains elevated



Source: BLS, Eurostat, BofA Global Research

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Fed & ECB: honing in on June

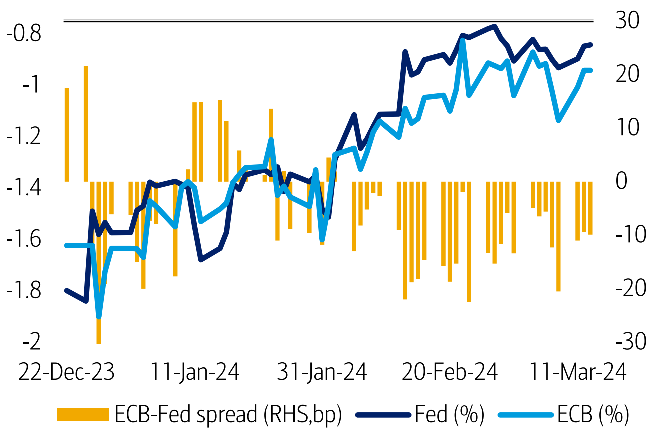
Ahead of next week's FOMC meeting, the latest policy cue the market has been left to digest was Chair Powell's Humphrey Hawkins testimony to Congress last week. The meeting was interpreted as marginally dovish by the market, though seemingly more for what he didn't say, rather than what he did. If there was a dovish comment to be found, it was the reference that the Fed needed was "close" to feel confident it could start cutting rates. But overall, markets were braced for Powell to express greater unease over the January inflation data than he did. The Fed's overall messaging remains that they don't need to see a marked improvement in the data, just more good readings. They are seen as a central bank that wants to start the cutting cycle, and a portion of the FX market sees this broadly, if realized, as the catalyst for the next trend lower in the USD. This can likely explain, in part, the USD's notable reaction to a more nuanced message.

In contrast, the March ECB meeting featured much more assertively hawkish language from President Lagarde. (Euro Area Watch: ECB review: June it is 07 March 2024)Throughout the press conference, she continued to steer the markets away from any cut expectations before June. Indeed, the ECB remains most notable concerned about wage inflation, and want better assurance that the risk of second round effects of price increases are mitigated by companies absorbing labor costs into profit margins. This will take time to assess, which is likely behind the ECB's perceived patience.

Incidentally, our economists call for both the Fed and ECB to start cutting rates in June, and both at a quarterly pace in 2024. Market pricing has been notably consistent with this, with total cuts through December for the Fed and ECB currently standing around 84 and 94bp, respectively. (Exhibit 6) However, as the Fed's upward pricing for December has seemingly peaked (for now), the EURUSD pair has rallied back to its 2-month highs. (Exhibit 7) As we've noted, previously, it's likely that US developments matter more for the FX market, as lower US yields in aggregate alleviate pressure globally, which should be incrementally constructive for global growth and risk assets.

Exhibit 5: OIS pricing of Fed and ECB cuts through Dec '24

Fed and ECB pricing have generally tracked this year; spread narrowing slightly in recent weeks



Source: Bloomberg; BofA Global Research

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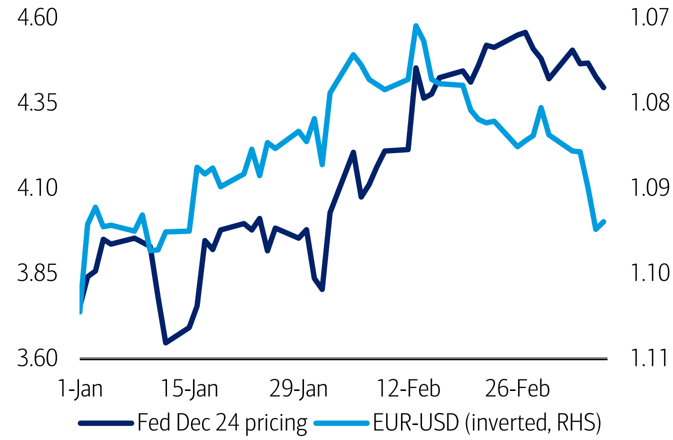
Exhibit 6: Fed Pricing (Dec '24) and EUR/USD (inverted)

EURUSD appreciated as Dec Fed pricing peaked



Source: Bloomberg; BofA Global Research

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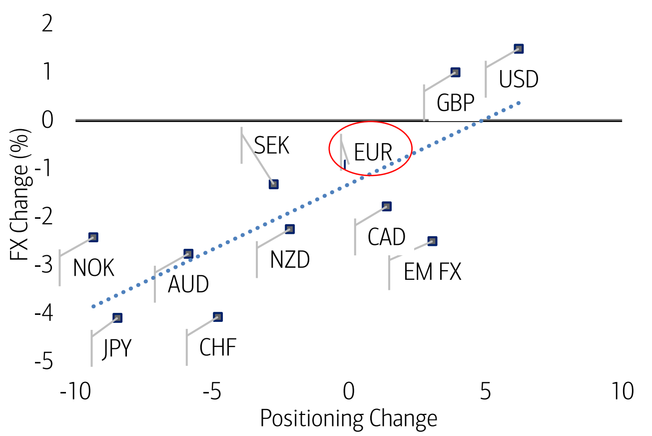
Positioning: EUR flat for now

Finally, investor positioning adjustments this year have been in line with the price action, with investors buying the USD after selling it in November and December. (Exhibit 8) On the EUR side, flows have been mixed, with Hedge Funds paring back their EUR shorts while Real Money has reduced their longs. Overall BofA investors are roughly neutral on EURUSD: higher EURUSD would rely more on Hedge Funds but lower EURUSD would rely more on Real Money. (Exhibit 9)

Exhibit 7: YTD changes in aggregate positioning vs FX
G10 positioning changes have correlated well with FX moves to start the year; EUR movements relatively subdued



Source: BofA Global Research

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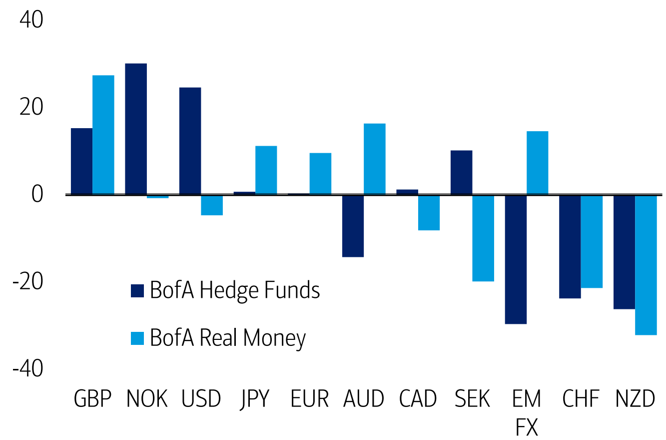
Exhibit 8: Latest BofA investor positioning: hedge funds & real money
EUR positioning neutral; hedge funds relatively long USD



Source: BofA Global Research. Equal weights for Hedge Funds and Real Money. +50 (-50) represents max long (short) positioning vs history

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Bottom line

Developments in FX markets remain fluid as we inch closer to the potential beginning of the global cutting cycle. Notable risks remain in all directions, but our current base case remains that the expected "soft landing" and growth recoupling will result in the Fed and ECB adjusting policy in lock step this year. Nascent data trends in both regions suggests we may be seeing early signs of this growth convergence between US and Euro area. This, along with the USD's overvaluation, is the basis of our EURUSD forecasts of 1.15 by YE 2024 and 1.20 by YE 2025. (Liquid Insight: Holdovers in G10 FX 29 February 2024)

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Ahead of a busy week, **Liquid Cross Border Flows**, 4 Mar 2024

Rates, FX & EM trades for 2024

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: The June target 08 March 2024

Global Rates Weekly: Double WAMmy 08 March 2024

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