EURUSD UPDATE

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EURUSD hits a top

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INTRODUCTION

- Softening leading indicators in the US, alongside the announcement of greater fiscal spending in Europe, have together seen a narrative flip in favour of EURUSD upside.
- We expect eurozone optimism to peter out in the coming weeks as the practical realities associated with greater fiscal support emerge.
- In the US, hard data should push back against any immediate growth concerns, though markets may need another round or two of data to see recession fears fully assuaged.
- Meanwhile, tariffs remain an underpriced risk in favour of EURUSD downside – albeit we only expect these to begin crystalising post-April 2nd.
- Accordingly, while we see some scope for EURUSD upside in the very short term, fundamentals favour a retracement lower in the coming months.
- We expect the pair to slip back to 1.03 over a 3-month time horizon before rallying more sustainably through the second half of the year.

Last week saw a remarkable turnaround for the euro. Having ended February trading sub-1.04, many, including ourselves, entered March expecting to see EURUSD parity in the coming months. Following more recent developments, however, this now looks an improbable outcome. The pair finished last week threatening 1.09, with more recent price action seeing EURUSD break above that barrier, topping out at levels last seen in October 2024. Even so, we do not expect this bout of euro upside to prove durable. Fundamentals suggest that a pullback for the pair is likely over the medium term, before a more sustainable EURUSD rally plays out in the second half of the year.

After trading rangebound through January and February, early March saw a sharp EURUSD rally, albeit one we think looks stretched

EURUSD caught in a perfect storm

Before exploring why we think the current EURUSD strength is unlikely to be sustained, we need to understand the catalysts underpinning the pair’s recent move higher. On the US side of the equation, continued growth exceptionalism has been a key factor underpinning dollar valuations in the post-election period. Markets had been positioned for increased fiscal spending and a reduction in red tape, assuming the more growth-negative policies put forward, were merely bluster. This theme has come under pressure in recent weeks, prompted by the Trump administration’s use of tariffs and tariff threats, and the unsettling efforts of DOGE. The resulting uncertainty has seen a sharp fall in sentiment readings, and of forward-looking indicators, triggering recession speculation in some quarters.

> "Fed easing bets have accelerated in turn – having priced just one 2025 rate cut in mid-February, markets now project three rate cuts this year. All told, this reversal in perception has weighed heavily on the dollar."

Set against this, Trump's transactional approach to geopolitics, and particularly to the Russia-Ukraine conflict, has sparked notable concern from European leaders. In response, last week saw the European Commission surprise markets, triggering national escape clauses from the Stability and Growth Pact, unlocking 650bn euros of national spending. This, alongside other measures, implies up to 800bn in additional fiscal support across the EU, primarily to fund re-armament. Meanwhile, in Germany, Chancellor-in-waiting Merz announced a similarly unexpected proposal to reform Germany's debt break, a change that would allow for a significant ramp-up in defence spending, while also floating the idea of a 500bn euro fund for infrastructure investment. For context, the fund that accompanied Olaf Sholz's much-feted Zeitenwende announcement totalled just 100bn euros. If realised, this set of measures would offer a significant boost to European growth. It should also be supportive of both price pressures and policy rates, while the prospect of higher defence spending is already proving positive for European equities.

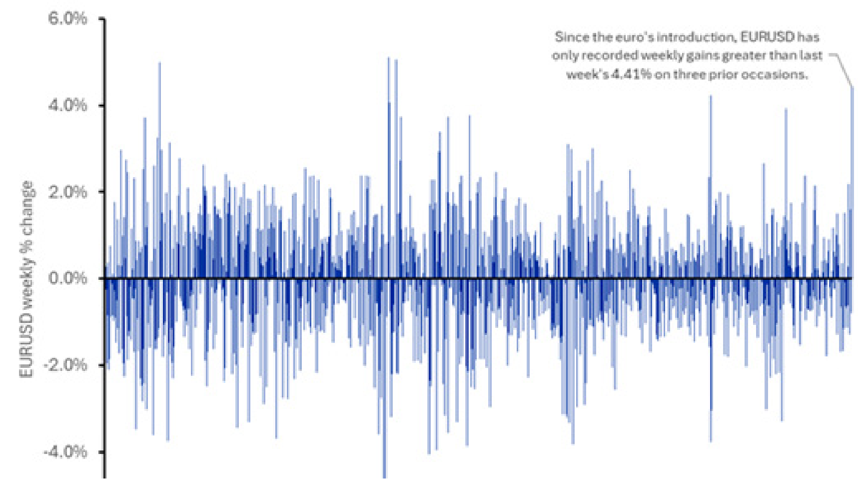
> "In short, this flips the narrative for the eurozone, with similarly consequential impacts on the euro."

Taken together, this perceived role-reversal for the US and eurozone economies represents a perfect storm for euro upside, with expected growth and interest rate differentials moving sharply in favour of EURUSD appreciation since the start of March. Accompanied by portfolio reallocations chasing eurozone equity outperformance, this has helped the euro record a remarkable run-up against the dollar.

The euro's early March rally has few historic precedents

Given the confluence of factors underpinning last week's EURUSD rally, it is unsurprising to see the pair notch a strong return performance. In fact, since the euro was introduced, there are only three instances where the single currency posted a larger weekly gain versus the greenback than last week's 4.41%. These came in December 2000, December 2008, and March 2009. Indeed, by magnitude, a move of this size has only been exceeded on five total occasions including the aforementioned weeks, with two weekly falls greater than 5% both recorded in October 2008.

Last week's EURUSD rally represents the largest one-week gain for the pair in more than 15 years.

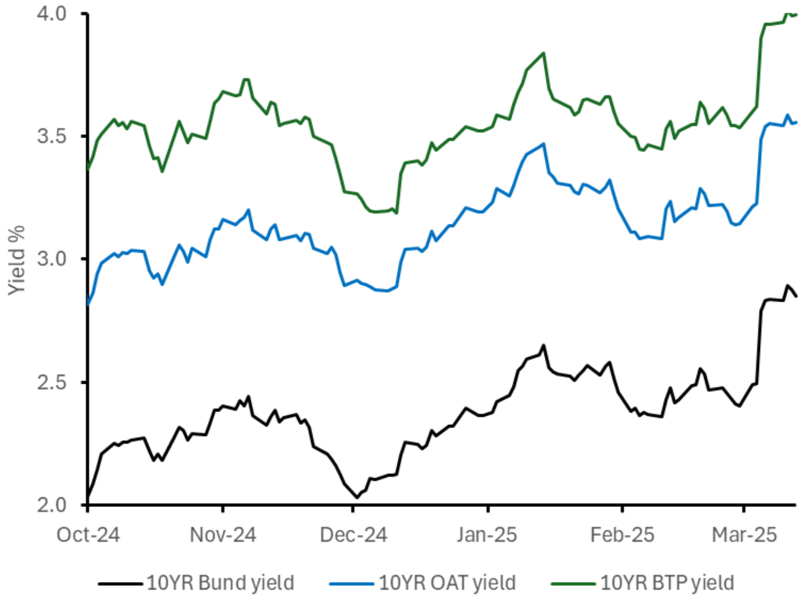


All this is to say, such moves are highly unusual. And, when they do occur, they are typically associated with major macroeconomic events, indicative of how markets are presently viewing last week's surprise news. We, however, remain circumspect. Our baseline assumption still holds that growth will continue to favour the US over coming months, with tariffs magnifying this dynamic for FX markets, while any lift to eurozone growth from additional government spending is likely to come later and be smaller than currently priced by markets.

Europe to underwhelm, at least short term

Starting with Europe - we expect that fiscal support will underwhelm. Taking the debate around NGEU funds as a baseline, initial optimism is likely to give way to disappointment on both implementation and effectiveness. Negotiations to agree a German spending package are proving fractious, raising risks that any eventual measures will prove less generous than initially suggested. Moreover, any such spending will likely take some time to materialise, both in Germany and the EU. Accordingly, our base case only embeds a meaningful growth uptick in 2026.

The growth impact of increased spending will not be visible for some time, but higher yields will push up borrowing costs with immediate effect.

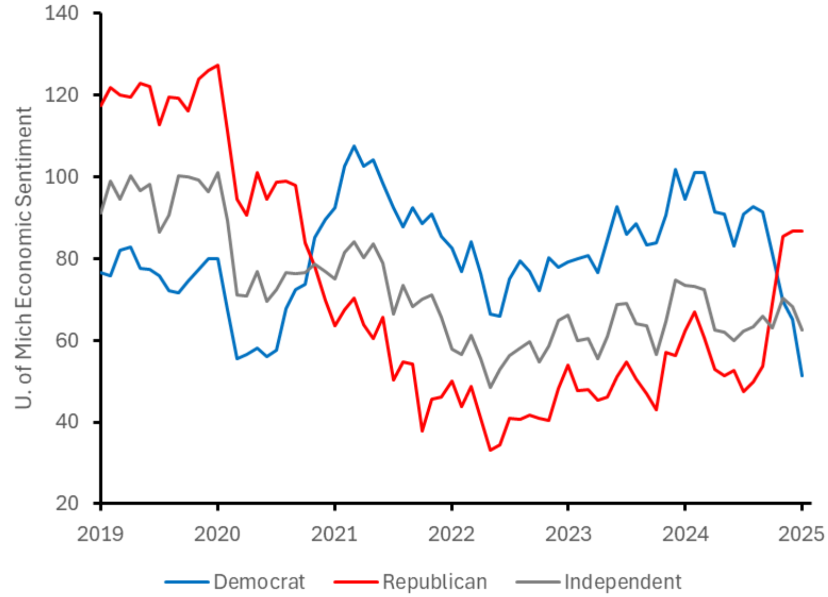


That said, the promise of increased spending is having a more immediate impact, translating into higher eurozone government bond yields, and will likely see the ECB truncate its easing cycle early. Not only will this prove a challenge to fiscal sustainability in other eurozone countries (France and Italy are front of mind on this score), but in isolation, rising interest rates should also weigh on growth across the bloc. This timing mismatch is likely to prove a drag on activity in the coming months, even if the fiscal impetus from greater government spending eventually proves growth-supportive.

US exceptionalism fading, but not dead yet

In contrast to market optimism for EU spending, expectations for the US economy have nosedived since mid-February. Here too though, we think markets have overreacted. Granted, sentiment readings have fallen sharply, but these are strongly correlated with political viewpoint. Accounting for this, the recent fall in aggregate expectations appears to be driven by Democrats, warning against the reliability of such measures as a forward-looking growth indicator. Similarly, some nowcasts have registered large declines in recent weeks, with the Atlanta Fed GDPNow model most notable. This went from predicting 2.3% QoQ annualised Q1 growth in late February, to -2.8% in early March. Subsequent digging by Fed staff discovered this was largely driven by unusual flows of physical gold, however. Adjust for this, and the model predicts growth of 0.4% QoQ annualised as of writing.

Political allegiance continues to drive economic sentiment, making the recent fall in expectations an unreliable economic indicator.



On the other hand, the hard data is yet to turn. Labour market readings remain solid, with 151k payroll gains in February, and an unemployment rate of 4.1%. Moreover, 4.0% YoY wage growth combined with core inflation of 3.1% points to inflation pressures much too hot for comfort at the Fed. And that is all before tariff impacts begin to push up prices, as is widely expected. And for all those focused on the stock market, the Fed still has a dual mandate, and that suggests that policy easing remains some way away based on recent data outturns.

"So, while markets have turned increasingly dovish on Fed expectations in recent weeks, we continue to project no cuts in 2025, while recession risks look overblown in our eyes."

Tariffs remain an overlooked catalyst

Beyond domestic US conditions, markets are yet to factor in the likely impact of tariffs. A focus on repeated US flip-flops obscures the fact that tariff barriers have risen over recent weeks and will almost certainly continue to do so moving forward. Granted, this will be a drag on US growth, but tariffs will weigh on activity elsewhere too. Markets have been happy to trade the first of these themes, but slow to price the latter, leaving minimal risk premia priced into FX pairs and the dollar unduly cheap.

"We expect this to become clearer as the Trump administration shifts tack, moving from using tariffs as a negotiating tactic, to a tool for boosting domestic manufacturing and raising revenue."

Our base case looks for this in April, shortly after Federal agencies are due to report on US trade policy. Trump has set a deadline of April 2nd for implementing global reciprocal tariffs – a threat we view as credible but underpriced by markets.

Passing the peak

Take these factors together, and EURUSD looks set for a reversal. Europe has likely seen peak optimism, and sentiment should turn less supportive for the euro moving forward. In contrast, US growth concerns look overstated. Further solid data prints should assuage recession fears and prompt a paring back of Fed easing bets, helping the dollar to retrace some recent losses.

Meanwhile, tariffs are still coming and remain a dollar-positive factor on balance. Absent another surprise then, the next leg for the pair should be lower. We look for the pair to bottom out around 1.03 over a three-month time horizon.

"Further out, fundamentals should progressively turn more supportive for EURUSD. While current move looks stretched, we do expect growth and rate differentials to prompt upside more sustainably through the second half of the year. Under our baseline forecast, this implies a slow grind higher for the EURUSD from mid-2025 onwards, projecting the pair at 1.08-1.10 by year-end."

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