

FX7 Charts

Divergent interest rate and currency trends feed uncertainty



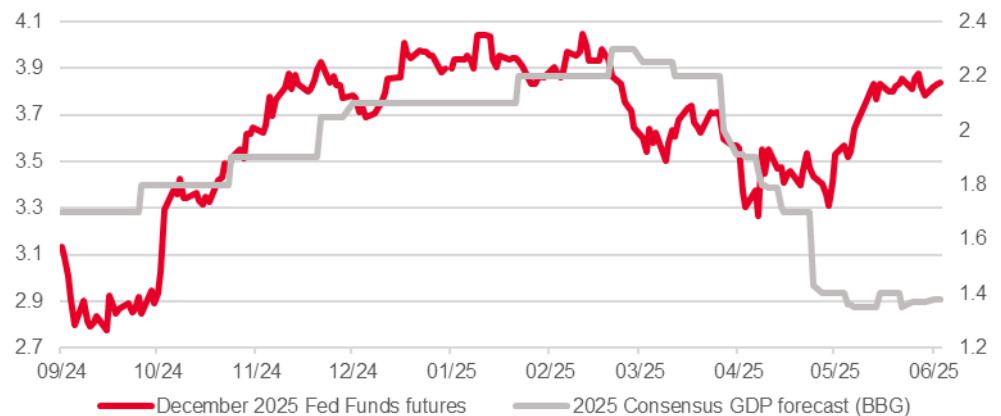
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#1 Chart of the week: Mind that rates/growth gap

The rates market has already given up on the US tariff slowdown



Source: Bloomberg, SG Cross Asset Research/Forex

Last week, we highlighted the importance of growth expectations in driving recent FX moves, as various correlations break down. This week, we examine the divergence between the rates market and consensus forecasts. Economic forecasts tend to be lagging indicators—not so much because economists are slow to react to news, but because the process of updating a forecast takes time. However, the gap between the consensus forecasts for US GDP growth, which Bloomberg updates regularly, and the behaviour of the front end of the rates market is now substantial. Some of this discrepancy arises because the impact of tariffs on the US economy, when finally felt, will manifest as higher prices, leading to weaker demand. Nevertheless, this gap appears unsustainable. How it is resolved will significantly affect the FX market.

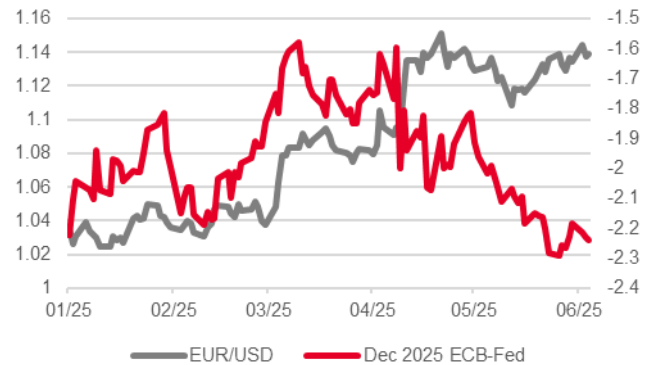
#2 FX is following growth, and ignoring rates (for now)

EUR/USD is still tracking growth expectations, mostly



Source: SG Cross Asset Research/Forex

And is still ignoring what is happening in the rates market



Source: SG Cross Asset Research/Forex

At the moment, the gap between rate pricing and consensus growth forecasts is reflected in a significant disparity between relative rate trends and EUR/USD. This is definitely keeping us awake at night! Growth and interest rate trends will eventually start moving in sync again. However, we expect this to result not in a reversal of the dollar's decline, but in the evolution of a new trading range. We anticipate EUR/USD to trade within its current range in the coming months and then move higher if the US economy slows in H2, ultimately settling into a new range centered around EUR/USD 1.20 in 2026.

#3 Do nowcasts help?

If consensus GDP forecasts have flaws, maybe nowcasts are a better guide?

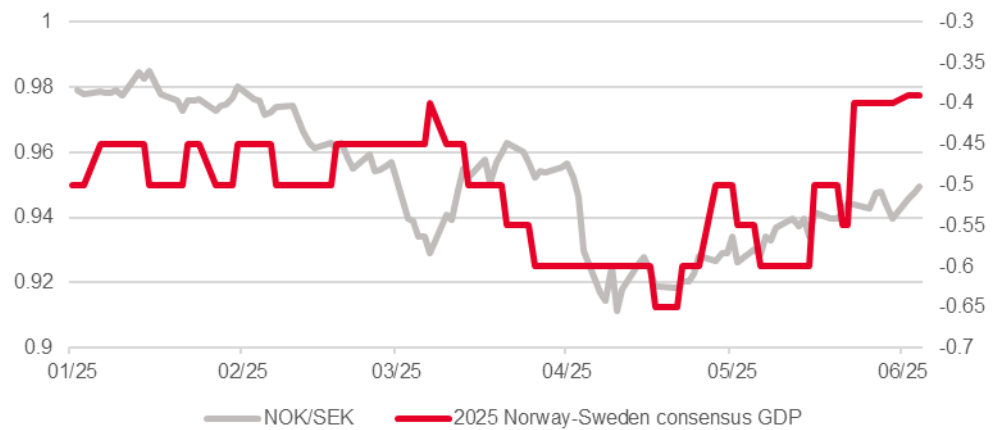


Source: Bloomberg, SG Cross Asset Research/Forex

Finally, in the spirit of trying out new indicators, here is the Bloomberg GDP nowcast, which aims to forecast quarterly GDP growth (in this case, relative current-quarter growth). These nowcasts do a good job of capturing the improvement in the European outlook relative to the US that we observed between February and April and suggest we have only reversed some of that progress in May. However, that still doesn't persuade us that EUR/USD can make significant gains from here.

#4 Norway's growth forecasts are laying catch-up

Consensus GDP forecasts for Norway are closing the gap with Sweden's



Source: SG Cross Asset Research/Forex

The SEK received a boost from the prospect of increased defense spending in Europe, reflected in a dip in Norway's GDP forecasts relative to Sweden's. That relative decline in Norway's growth forecasts has now been more than fully reversed, which suggests the uptrend in NOK/SEK (and the downtrend in EUR/NOK) has further to go.

#5 FX/rates correlations: the EUR/SEK exception

While G10 FX has broken free from relative rates, EUR/SEK is reconnecting



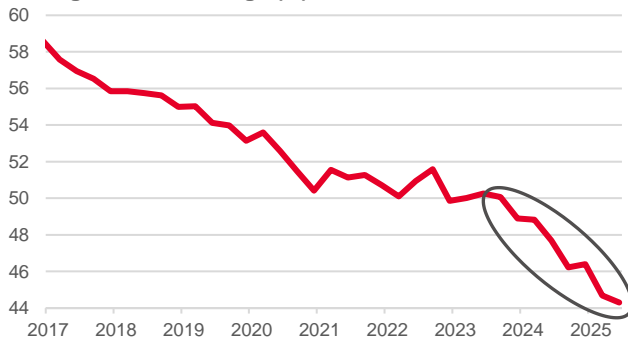
Source: SG Cross Asset Research/Forex

Relative rates currently have weak explanatory power for G10 currencies, where growth expectations are now playing a bigger role. However, EUR/SEK is an exception this spring, as the pair has been tracking relative rates since February, whereas its correlation with European equities has broken down. While the rates differential remains stable for now, it suggests that monetary policy divergence between the ECB and the Riksbank could trigger the next EUR/SEK trend.

#6 Dedollarization benefits to the smallest currencies

USD holdings have been decreasing again since 3Q23...

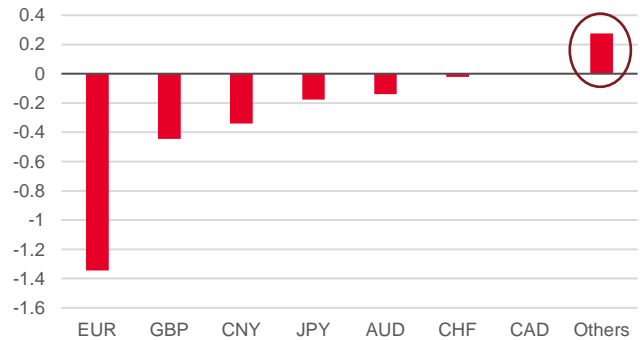
USD global FX holdings (%)



Source: Bloomberg/IMF, SG Cross Asset Research/Forex

...and have only benefited gold and small currency

FX holdings changes since 3Q 23



Source: Bloomberg/IMF, SG Cross Asset Research/Forex

The erosion of the dollar's share in global FX reserves, or dedollarization, paused during the COVID crisis in 2020 but resumed in the second half of 2023. Since 3Q23, the share of USD FX reserves has fallen below 50%, representing a decline of -5.8%. The main beneficiary has been gold, which increased by +7.9% to 23.3%, reflecting how central banks are diversifying their dollar holdings. Surprisingly, the dedollarization process has not benefited any of the major reserve currencies. Instead, only the share of the 'Others' category in the IMF's classification has increased over the same period, with Asian and Nordic currencies likely being the most represented.

#7 EUR/USD skew shows unprecedented regime change

Since 2005, EUR/USD risk reversals never stayed so long above 0.5 for EUR calls

EUR/USD 3m risk reversal



Source: SG Cross Asset Research/Forex

Over the past two decades, EUR/USD risk reversals have been structurally oriented towards EUR downside most of the time. Until now, the skew flipped to the bullish side only briefly and occasionally. However, the current bullish pricing has persisted for nearly a full month, something that has not occurred in the past 20 years. The ECB's expected 25bp cut this week is unlikely to discourage these EUR bullish bets. The options market might be experiencing a paradigm shift, where dollar declines are expected to be more turbulent than dollar gains, challenging the greenback's safe-haven status.

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