

Target change for the EURUSD

EURUSD Target change to 1.15

The EURUSD (value of one euro) has been trading in a wide range (1.08-1.12) since the tariff's announcements. The recent USD weakness has surprised as the American currency is usually a defensive currency generally benefiting from high uncertainty. Other forces seem to be at play in this unusual environment. The announcement on Thursday April 3rd of reciprocal tariffs at a level unseen for about a century has been a shock for countries and markets. Even if negotiations will likely take place following the announcement of a 90-day pause, it is very unlikely that the tariffs will be revised to a level anywhere close to the last few decades. Indeed, Donald Trump still sees the tariffs as a recurrent source of income allowing to finance a tax cut that would limit the negative effects on the purchasing power on low to medium income households. High tariffs could reduce the potential of the US growth in the coming years and there is a risk of stagflation (low growth with persistent high inflation). The second reason or a change in the demand for the USD is related to the funding of the US current account deficit. Indeed, it is mainly funded by foreign buying of fixed income, primarily by European, Japanese but also Chinese investors. Higher uncertainty regarding the US outlook and better growth prospects in Europe probably motivate these investors to diversify their portfolios away from the US into Europe. **Taking these factors into account, we have changed our 3-month target from 1.05 to 1.12 and our 12-month target from 1.05 to 1.15 (value of one EUR). This suggests more downside for the USD.**

Why the interest rate differential could become less important

The Fed kept rates on hold at 4.5% while the ECB cut rates by 25bps to 2.5%, as expected in March. Powell assesses the competing risks of persistent inflation and a potential economic slowdown, just as the ECB is weighing the impact of tariffs and fiscal expansion on inflation and the impact of uncertainty on the economy. The market still expects more than 3 rate cuts from the Fed and around 2 from the ECB. This compares to 2 and 2 in our scenario. That as such does not suggest a major upside for the EURUSD.

Usually, the interest rate differential is among the best indicator to forecast exchange rates over one year. We have however seen some exceptions in the past. Indeed, the EURUSD rose from 1.05 in January 2017 to 1.25 in February 2018 despite a 2-year interest rate differential rising by around 100bp in favour of the USD. There is a risk of a repeat of the 2017 situation suggesting that the rate differential could be less relevant. One should also stress that the expected return differential for equities should also be considered when forecasting the demand for the USD relative to the EUR. We see reasons to believe that this differential has become less in favor of the USD. As a result, we have turned more cautious on US equities relative to the eurozone.

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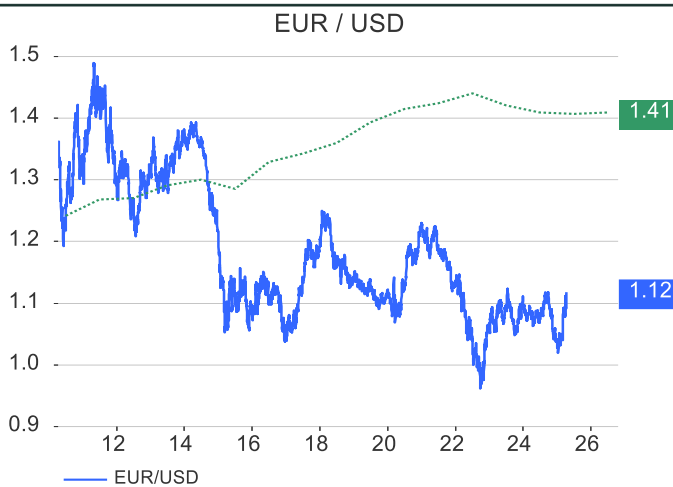
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Medium-term drivers

In the medium term, the key driver will remain the Purchasing Power Parity (PPP). It measures the exchange rate that equalizes the price of a representative basket of goods when calculated in dollars. The estimated long-term fair value for one euro ("Purchasing Power Parity" or PPP) provided by the OECD is around 1.41 dollars (based on Germany's figures). Deviations from PPP can however be seen over a long period. Some academic studies suggest that a more relevant approach would be the so-called notion of half-life*. Following Craig (2005) "a half-life represents the amount of time that elapses before a discrepancy between the PPP level and the current exchange rate is half its current size". He found that for large differences, that period could be around 12 to 18 months. Currently, the notion of half-life suggests a fair value of one euro of around 1.26.

EURUSD LONG-TERM FAIR VALUE



* For example, see B. Craig (2005) "The Growing Significance of Purchasing Power Parity", Federal Reserve Bank of Cleveland, Economic Commentary.

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