EUR
Update

February 2022

MONEX

Fluid backdrop to keep volatility elevated

Author

Ima Sammani
FX Market Analyst
+31 (0)20 808 3644
Ima.Sammani@monexeurope.com

Two months in and 2022 has already made for a turbulent year for the euro given the volatile monetary outlook and heightened regional geopolitical risks. In January, a staggeringly hawkish rate path for the Fed, as implied by short-term interest rate instruments, sent EURUSD down to the 1.11 handle, with the year-to-date low registered when Fed Chair Powell signalled there is "plenty of room to raise rates". Not long after, the European Central Bank switched sides to team hawk as ECB President Lagarde emphasised the upside risks to inflation at February's meeting. This, along with a reluctance by Lagarde to deny a rate hike in 2022 like she did in December's meeting, led markets to believe a hawkish pivot at the March meeting is incoming. This helped EURUSD to recover back to 1.1450 before several ECB speakers spoke to the media and stated markets were getting ahead of themselves, capping some of the euro's gains. On top of the pushback by some Governing Council members, headlines confirming that a Russian invasion in Ukraine is becoming more likely weighed on the single currency as Europe's gas supply, and in turn its inflationary backdrop is at stake. It must be noted that the deterioration in the eurozone risk profile wasn't enough to fully offset the impact of the hawkish ECB meeting, however. A hawkish ECB was one of the biggest upside risks to our EURUSD forecasts as outlined in our February forecasts, and this upside risk is now likely to materialise more meaningfully in March.

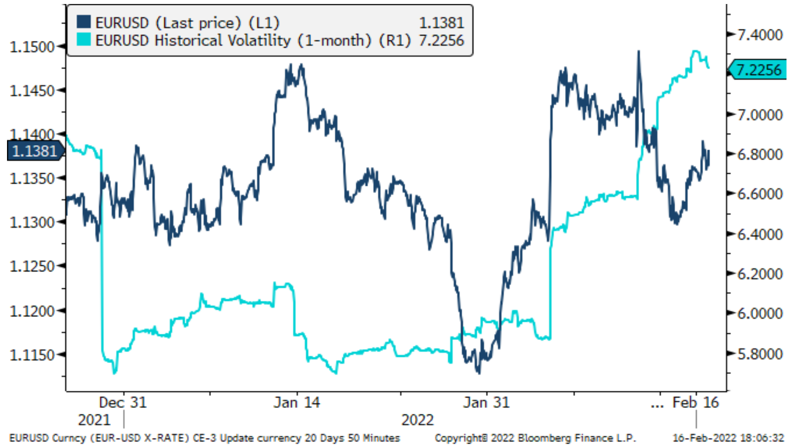
> This has resulted in an upwards adjustment to our **front-end EURUSD calls** to account for the recent change in tone by the central bank.

Our medium-term forecasts are unchanged, however, as we do believe that market pricing is still fairly aggressive for the ECB this year and for now do not expect the ECB to follow market expectations 1:1. Our near-term EURUSD projections are subject to review in the coming months given the fluid nature of the geopolitical backdrop and the uncertain market reaction to upcoming central bank meetings.

Monex's forecasts

	1-month	3-month	6-month	12-month
EURUSD	1.13	1.14	1.13	1.14

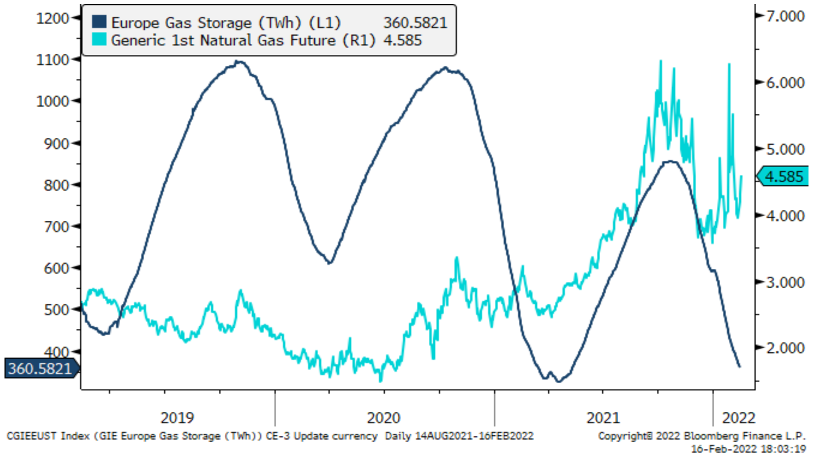
Volatility in 2022 has been elevated so far given the fluid backdrop around EURUSD



Russia-Ukraine tensions hit the euro with a strong jab; outlook remains uncertain

While the euro has been partly supported by the hawkish repricing of ECB policy expectations, the rise in tensions between Russia and Ukraine and the uncertainties around a potential Russian invasion, with all the consequences that will entail, has been notably weighing on the euro over recent months. This is in part due to overall sentiment in the bloc being more tentative as regional political risks have simply increased, which has at times benefited the regional safe haven Swiss franc but also meant the euro was an easy target for capital outflows. At the same time, Europe's reliance on Russia for natural gas and precious metals also made the euro vulnerable. Last September, prior to the increase in geopolitical risk, reports suggested that Russia slowed gas supplies to Europe, which added to the backdrop of high global gas demand and bottlenecked supplies. This, along with record low inventory levels in the eurozone and expectations of a more energy intensive winter, sent European gas prices to record levels. The Kremlin has so far denied restricting gas supply to Europe, but some see the move as extortion aimed as leverage in a dispute over the Gazprom-backed Nord Stream 2 pipeline project.

Natural gas prices have risen to record highs, but storage levels are of no support to markets



With European gas futures still trading at elevated levels, the threat of sanctions from the West if Russia invades Ukraine could result in countermeasures from Russia that would further restrict gas flows into the eurozone; 35% of EU gas supply is imported from Russia. EU sanctions could also focus on the contentious Nord Stream 2 project. The pipeline's controversy lies in the fact that Europe already relies on Russia for a large proportion of its natural gas requirements and approving the pipeline would double the annual capacity of the existing NS pipeline. This would give Russia much more leverage in Europe, making the approval of the pipeline a highly politicised decision. The US has already stated Nord Stream 2 will not move forward in case of an invasion, but existing pipelines are also at stake should tensions further escalate, given Europe's substantial reliance on Russian gas. This means European natural gas prices are likely to remain highly volatile until the geopolitical backdrop eases, adding onto inflation expectations in the eurozone, which could force the ECB to move quicker on policy tightening than they had in mind. Overall, the eurozone's risk profile is quite substantive and EURUSD is likely to remain highly sensitive to any developments.

Volatile rate environment leaves EURUSD vulnerable

Looking ahead, ongoing political risk in Europe means EURUSD is going to remain an easy target within the G10, especially with US Treasury yields rising simultaneously and the euro's sensitivity to them. The hawkish repricing of ECB expectations does provide a backstop for EURUSD, which partly offsets the impact of rising US yields, but the extent hereof remains in question. Looking over to H2, an improvement in global growth conditions will be more deterministic for the euro when the monetary outlook and political backdrop has become more stable. Downside risks to our forecasts include further significant increases in US Treasury yields, signs of an invasion in Ukraine and any return of lockdown measures – although the latter has gained decreasing focus recently given the improving health backdrop. Upside risks centre on the further broadening of price pressures in the eurozone, which will encourage ECB policymakers to speed up policy normalisation, and signs of disinflationary pressures in the US that would result in less hawkish market pricing of US rates. Next month's ECB and Fed policy meetings will prove key in gauging the next leg for EURUSD. The risks are more balanced towards the Fed underdelivering given the aggressive pricing in markets: a 50bps rate hike is currently baked in, meaning the US dollar is unlikely to trade much higher on the back of a larger rate hike while anything below 50bps will come as a dovish surprise.

Similarly, risks for the **ECB** are also tilted towards underdelivery in the March meeting as the focus in recent ECB commentary has primarily been on pushing back against rate expectations.

MONEX

Disclaimer