EUR Update

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European currencies battered by latest Russia-Ukraine headlines - is there a floor?

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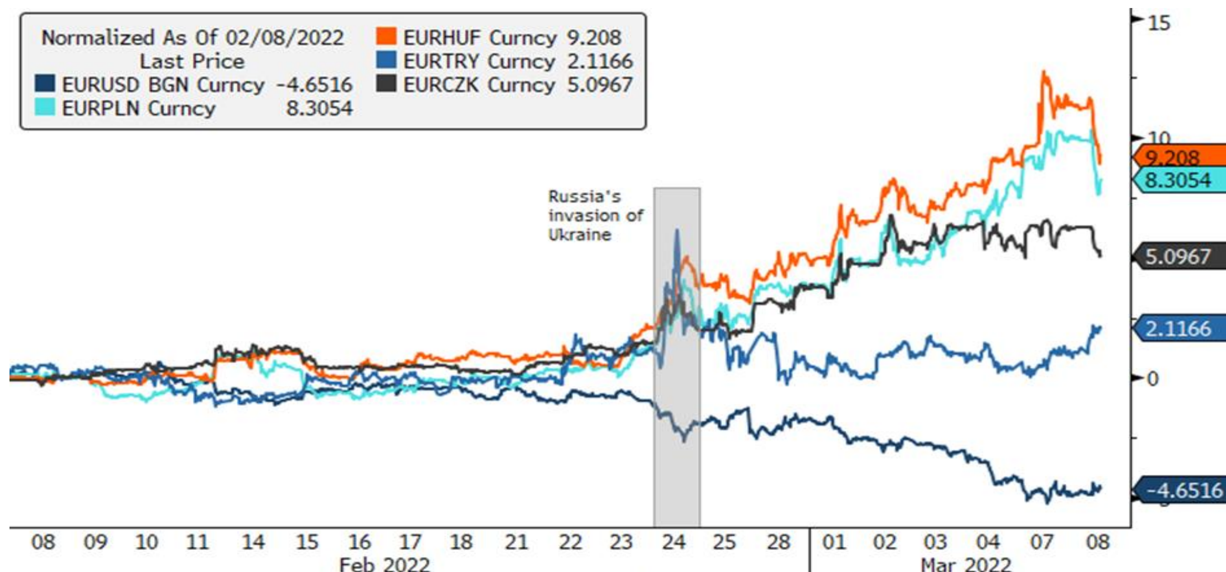
Since the publication of our latest FX forecasts at the beginning of the month, significant developments in the Russia-Ukraine war have put increased pressure on European currencies and equities. This was due to the increasing likelihood that sanctions would be imposed on Russian energy supplies along with signs that Russian forces would continue to increase aggressiveness. Talks around commodity-related sanctions pushed EURUSD to May 2020 levels of 1.080, as eurozone inflation expectations remain highly vulnerable to the energy outlook. This is especially the case as the eurozone imports 40% of its gas from Russia, and restricted supply due to sanctions would only further drive up prices. A similar reliance on Russian energy applies to currencies of Poland, Hungary, the Czech Republic, and Turkey.

Over the last month, the respective currencies of these nations have therefore performed even worse than the euro.

The question now is; where will price action stabilise?

Percentage changes in European currencies shows EURUSD is trading nearly 5% lower since February 8th, but CEEMEA currencies are faring even worse as their losses against the euro are even more substantial



Commodity bans and inflation risks keep European central banks in a sticky spot

The US announced on Tuesday it will ban the imports of Russian oil and gas into the US in an attempt to deprive Russia of its crude oil revenue. The UK followed suit and plans to fade out Russian imports of oil entirely by the end of 2022, but the EU remains divided over Russian oil or gas sanctions: Germany, who together with Italy accounts for nearly half of EU gas imports from Russia, opposes such an abrupt move, while Poland is pushing the bloc to target crude. The EU's decision requires unanimity, which now seems a long way off, but FX markets are already responding to the mere prospect of such actions and the impact US and UK sanctions are having on global commodity prices. Reports suggest Europe is drawing up plans to limit its reliance on Russian energy by almost 80% this year, however, this is unfeasible in the near future, leaving the euro exposed to developments around commodities sanctions.

A warning from Russia over cutting off gas supply further exacerbates market concerns over supply shortages. Russia has warned the West it could close its Nord Stream I pipeline, the main natural gas pipeline in Europe that runs from Russia to Germany, and stated oil prices can spike to over $300/b if governments target Russia's energy supplies with sanctions. While European dependency on Russia means the EU is hesitant about sanctions in the near-term, Russia would also have a difficult time cutting off European gas as most of Russia's fiscal revenue comes from oil, while Europe is Gazprom's key delivery market.

> "However, despite the deteriorating commodities outlook inflating bearish bets on the euro, signs of a fiscal response from the EU has helped stabilise European currencies and stocks lately."

Later this week at the informal EU leaders summit in Versailles, the EU is set to unveil a plan to jointly issue bonds to finance energy and defense spending – the details of which are currently unspecified. Still, the news that the EU is looking into increasing fiscal spending to account for the surges in energy prices has soothed some concerns for euro traders as this would be net positive for eurozone economic growth, reducing concerns around stagflation. At the moment, the big unknowns about the plan mean FX markets are not getting too ahead of themselves as downside risks are still plentiful, however, mere talks about the increased has lifted EURUSD back up to the 1.09 level. While this is a minor reprieve, the euro continues to trade over 2.5% lower compared to levels before the Russian invasion of the Donbas region. Similar to the euro, the news of growth supportive fiscal stimulus in the eurozone has helped CE-3 currencies partially retrace recent losses; both PLN and HUF have gains over 3% against the euro in the past two day, while CZK is up over 1.5%.

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In the EM space, central banks have sped up rate hikes to keep up with inflation expectations, with the National Bank of Poland hiking rates by 75bps on Tuesday, while the Hungarian National Bank hiked rates by 50bps towards the end of February.

While the initial responses by these central banks was to tighten policy to control the inflation pass-through and anchor both inflation expectations and their domestic currencies, they will also have to weigh the risks of tighter policy in promoting a stagflationary macro environment. Even before the war in Ukraine, high inflation in Poland and Hungary was already a major source of concern, and with EM rates rising out of necessity, this naturally slows down their economic growth. Still, markets deem the rate hikes necessary and have been pricing near-term tightening more aggressively than economists. This has acted as a source of defence for the flailing currencies thus far. Unlike CE-3 central banks, however, the ECB is in a more precarious position. After signalling that policy is likely to change at March's meeting back in February, the downside risks of the war in Ukraine are likely to see the ECB take a more cautious stance as growth risks are weighed more heavily. This view is widely held and is visible in market pricing of the ECB's normalisation profile this year; expectations of rate hikes have moderated from nearly 50bps in mid-February to just 20bps now. A major source of uncertainty in ECB policy is now in its sequencing of monetary tightening. Previously, the ECB looked to end its QE programme before raising rates, however, the Governing Council may now look to raise interest rates while still purchasing government debt in order to smooth peripheral eurozone bond markets as they are likely to show signs of strain under lower growth expectations.

A break in the clouds provides some relief, but downside risks are still extreme

While the recent sell-off in global FX has been substantive, our longer-form calls are unchanged for now. If history is any guide, aggressive sell-offs in times of war are oftentimes followed by aggressive bounce backs too, once conditions stabilise and risk premiums are wound down. With the current risk environment being so uncertain, it is difficult to justify changes to our longer-form calls, largely due to the risk of conditions stabilising and currencies bouncing back. However, it is worth noting that downside risks to these calls have increased, largely due to the lower eurozone growth profile as things currently stand. Similarly, we have maintained our near-term EURUSD forecasts too. This largely owes to recent developments which have seen very tentative signs of initial de-escalation in Ukraine with both sides toning down their demands in peace talks and increased likelihood of increased fiscal support in the eurozone, which has partly offset the downside risk that was priced in last week. Given the fluidity of the situation, however, our near-term EURUSD forecasts remain under constant review, but we deem the distribution of risks broadly balanced around the 1.10 mark as things stand.

Downside risks include sanctions on crude oil from the EU, which will drive up inflation fears significantly and could see panic tightening by the ECB while the euro weakens, along with bureaucracy hindering the EU's ability to loosen the fiscal taps at a supranational level. The worst-case scenario for European currencies would be an expansion of the war into neighbouring countries, although this is an extreme tail risk at present. To the upside, the safe passage of significant fiscal spending from the EU bloc in the form of joint bond sales to offset the impact of rising energy prices could put a floor under the euro, while an early de-escalation would see the single currency rebound more significantly. Both would likely promote expectations of ECB normalisation towards year-end.

Conversely, the deterioration in the regional risk profile has led us to **mark down our CE-3 forecasts further**.

Central bank actions have thus far had a limited impact on currency markets, even the NBP's direct FX intervention had a muted impact. While the potential improvement in the eurozone growth profile is supportive of a retracement, these currencies remain more sensitive to regional commodity prices and the status of the war due to their elevated risk premium.

Monex's revised March forecasts

	1-month	3-month	6-month	12-month
EURPLN	5.0	4.8	4.5	4.45
EURCZK	25.8	25.0	24.5	25.0
EURHUF	400	380	365	360

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