Sucden Financial

FX Monthly Report

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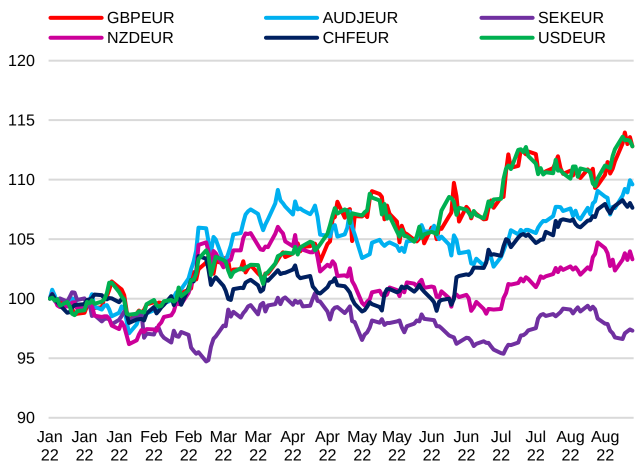
EUR Focus

The EURUSD has been decimated so far this year, as the value fell below the parity to 0.9925, a two-decade low, breaching the previous lows of 0.9952 that were seen in July. Prospects of a difficult winter amidst a growing energy crisis are driving a deeper descent for the currency. Pressure on existing energy supplies risks power rationing and blackouts during the last quarter of this year in Europe. However, the markets are already pricing in these moves, and the end of summer would put the EUR back under pressure. The region has been struggling with natural gas prices breaching new highs, with already-scarce resources further squeezed by disruption in the waterborne transportation of key commodities following an unusually dry summer. With the USD being well bid, that should further hand over EUR weakness.

EUR vs Major Currencies Indexed January 2022

EUR has been heavily sold off so far this year.



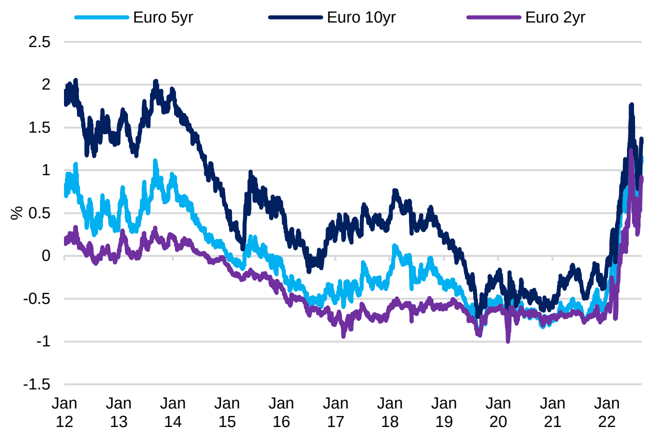
Source: Bloomberg, Sucden Financial

At the beginning of the year, it was unclear how far inflationary pressures would rise and how aggressively the central banks would have to respond to a persistent rise in prices. Now, we are at the stage where the Fed hiked by 150bps in two months, and the ECB also increased its rates in July. More than 100 central banks have now hiked this year, with many of them promising that more is to come. The divergence in the monetary policy poses a cautionary tale: it's easy for policymakers to fall behind the curve once inflation takes hold, a case that holds true for Europe.

Inflation remains a problem in Europe, with CPI figures reaching as far as 8.9% y/y in July, new record highs. At the same time, prices of natural gas continue to soar, breaking record highs, as Russian state-run producer Gazprom is adding uncertainty to imports into the bloc. More recently, the company said it would cut Nord Stream 1 deliveries from 40% capacity to 20%. The cutback, if implemented, will significantly dampen the EU's ability to stock up sufficiently by winter, with a current goal of 80% of storage capacity. At the same time, the bloc's governments pledged to reduce the consumption of Russian gas by 15% with an exemption for those that heavily rely on its exports. Overall, the bloc is preparing for a contingency situation of overall cut-off, but rationing would still need to take place to reserve energy. We are of the belief that Russia will cut enough shipments to create artificial tightness in the market and keep its revenues elevated, and would avoid a full-fledged freeze in the short term. More so, the escalation of the energy crisis and power rationing will further dampen the outlook for the Eurozone's performance, with countries such as Germany taking a hit to their consumption levels this winter. Growing energy prices should continue to drive the divergence between the exporters in the US and the importers in Europe, meaning a much greater conviction of a recession in Europe. According to the Bloomberg survey, the probability of recession in Europe in 12 months' time equals 60%, vs 40% for the US. As a result, the ECB's hawkishness is likely to be less prevalent than in the US.

Euro 2,5, and 10-year Yields

The yields softened from recent peaks in the last couple of months.

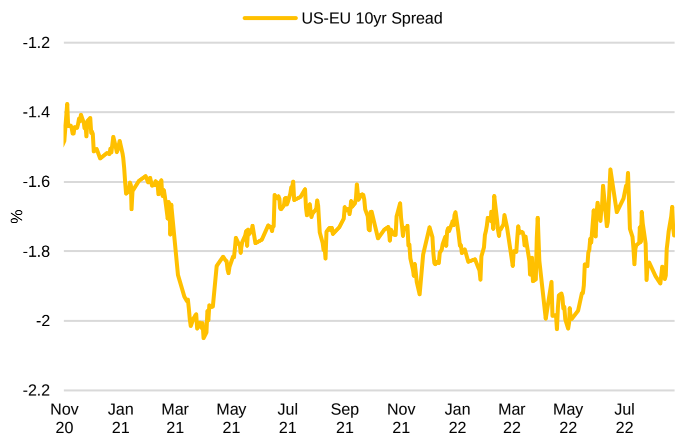


Source: Bloomberg, Sucden Financial

Furthermore, European economic growth is feeling the decline faster than its American counterpart, with the bloc's biggest economies, such as France and Germany shrinking on price squeeze. Manufacturing and service output for both economies is contracting for the first time in more than 18 months, as both countries succumbed to record inflation and increasing uncertainty surrounding the energy crisis. New orders are falling for both services and manufacturing, with firms now least confident since November 2020. For the bloc's performance overall, the service industry remained just above the expansionary level, while manufacturing plummeted. As a result, euro-area economic activity declined for the second straight month, signalling that Q3 performance is most likely to be contractionary.

US-EU 10-year Yield Spread

The spread between US and Europe has widened significantly.



Source: Bloomberg, Sucden Financial

As a result, the ECB will have to make a tough decision on how to address the inflation without damaging too much of the growth while also trying to import gas from other nations at a premium. In July, as expected, the ECB raised interest rates, however, the benchmark increased by more than expected, 50bps, as inflation continued to surge. However, the ECB is late to the game, and as a result, we have seen a sharp decline in the value of the EUR. Despite the clarity of policy decisions, the ECB is facing the challenge of assuring consistency of policy across the member states. As the ECB began to reduce its bond purchases, bond yields have rallied, however, to a different degree in different regions. The spreads between the 10yr bond yields in Germany and Italy have risen to 2.30% at the time of writing, the 2019 highs. This raises the possibility that the monetary policy tightening could disproportionately hurt some countries more than others, further adding uncertainty to the effectiveness of monetary policy moves from the ECB. This, as a result, should send the yield spread higher as some economies withstand the approaching recession better than others. The policymakers are working on instruments to help address these issues in case of escalation, however, this has done little to boost market sentiment.

EU Growth and Inflation Expectations

Inflation expectations continue to tick higher as growth prospects tumble.

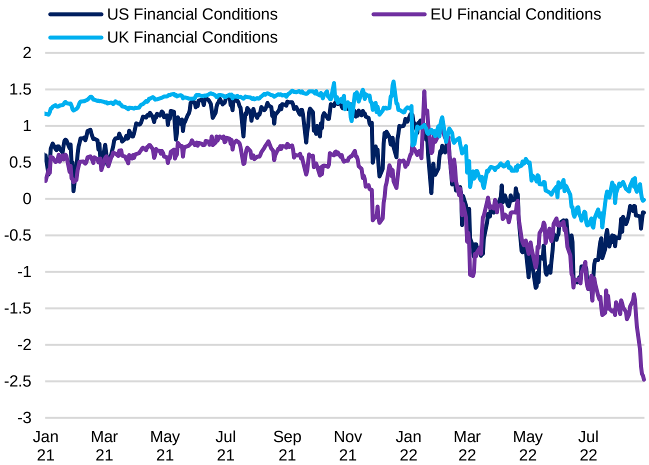
Source: ZEW Zentrum fuer Europaeische

The divergence between two major economies, Europe and the US, is driving the disparity between the two currencies' performance. EUR is likely to feel further pressure from this divergence, only with the next scheduled hike from the ECB at the beginning of September to give EUR a boost. A looming energy crisis is dampening Eurozone's outlook much faster than that of its Western counterparts, further weakening the appetite to invest in the region. The combination of the yield spreads, and the energy shock makes it a favourable environment for the USD, keeping EURUSD near parity for much of the remainder of 2022.

Currency View

US, UK, and Europe Monetary Policy Conditions

Financial Conditions have declined sharply in the last few months, with EU feeling the brunt of this decline.

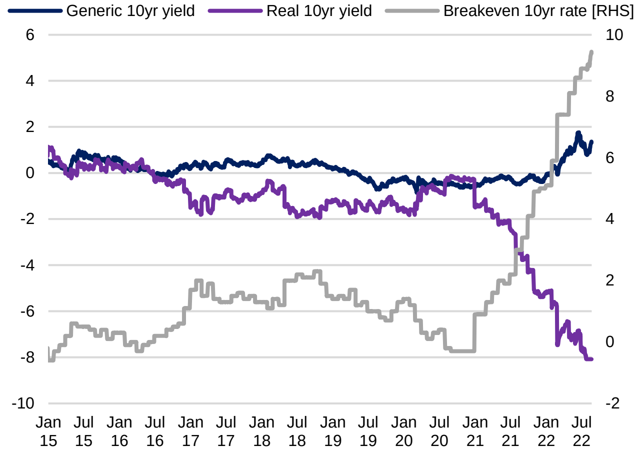


Source: Bloomberg

The ECB, in comparison to the Fed, seems to be behind the curve in its tightening monetary policy cycle. Despite that, the probability of recession is much more likely in Europe than it is in the US in 2022 due to the looming energy crisis and possible rationing of energy in the winter months. The short EUR trade remains intact with traders eyeing the 0.97 and 0.95 levels, however, looking at how far it's come from the risk reward is against traders, but we still see the EURUSD weakening. We could see more value playing out in the rates market with the ECB still to hike rates. The COT data shows that non-commercial net combined positions for the pair have now fallen to -42,103 contracts, the lowest since March 2020, settling up for a potential of an extended short. Most of the price action will be driven by the divergence of economic performance between the two economies. The question remains whether the policymakers will start discussing support for the currency now that it has broken below parity. That would provide a temporary boost for EUR, however, the USD remains robust. Further moves could also be spurred by European data and any moves that would confirm the slowing performance. We expect EUR to be under continued pressure against the USD, but with the ECB interest rate decision scheduled a couple of weeks before the Fed, another rate hike from the ECB could give EUR a temporary boost until the end of September. The EUR will also be susceptible to any changes in the underlying Fed expectations, as well as the ECB moves. For the USD, the upside still looks to have more room, with the possibility of reiterated hawkish comments from Fed Chair Jerome Powell at the Jackson Hole symposium later this week expected to give the USD another boost. There are few alternative investments to the USD at the moment.

EU Nominal and Real Yields vs Inflation Expectations

Inflation expectation gauge continues to surge higher as the ECB struggles to catch up with inflation.



Source: Bloomberg, Bloomberg Generic

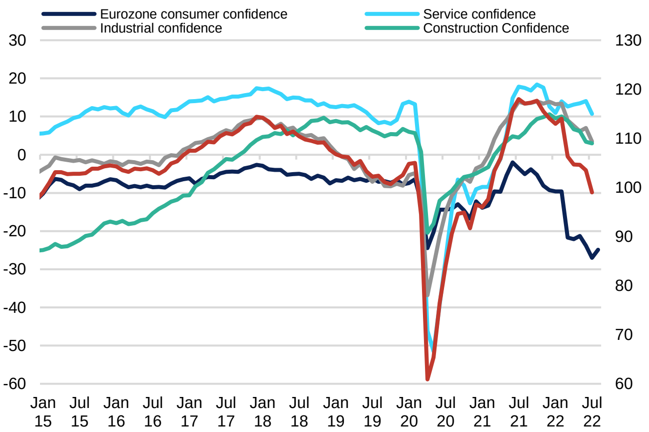
Desk Comments

Euro

EURUSD is again back below parity amid deteriorating economic outlook with a recession an almost certainty. While stagflation plagues majority of the globe, the Eurozone has been particularly hurt by an energy crisis, which has been one the key drivers in sending Euro lower, despite probability of higher rates compared to July. This coupled with markets flight to the safety of the USD as global recession fears intensifies has sent EURUSD down below parity. We believe a most of the negativity geared to the Eurozone has been priced in and only a further worsening on the energy crisis/ geopolitical backdrop or a further deterioration in global economic activity would lead to move down to 0.95. We expect the cross to consolidate around these levels with any rallies are likely to be short lived.

European Sentiment

European sentiment has nosedived in the last few months, we expect this to continue.



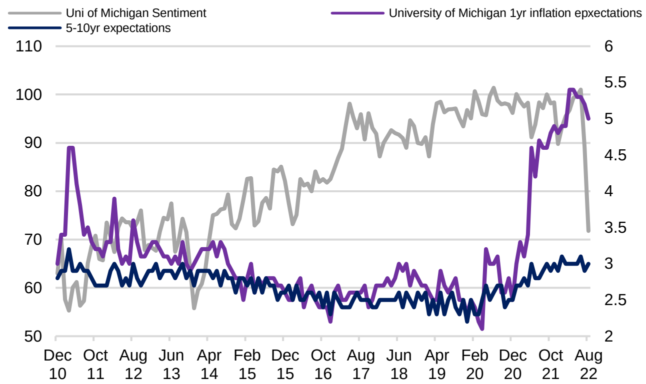
Source: European Commission

USD

USD Index gained in August aided by expectations of a more hawkish Fed leading markets pricing in higher rates going into Jackson Hole. USD has also been boosted by safe-haven flows. With terminal rate expectation now close to 4% by end of Q1 2023 its difficult to envisage this cropping much higher without fears of overtightening setting in. We expect the USD index to trace back down over the next few months, provided economic date does not deteriorate significantly which would spark more safe haven flows to USD amid fears of a deeper and prolonged recession.

US Michigan Sentiment Indicators

Sentiment is falling to multi-year lows, but inflation expectations are seen softening.



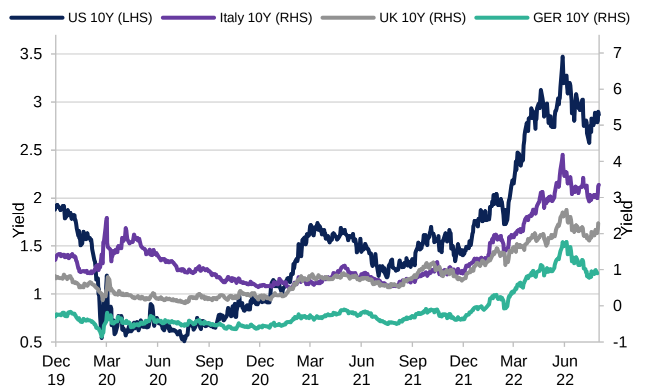
Source: University of Michigan

GBP

GBP made fresh lows vs USD as fears of a deep recession amid higher-than-expected CPI print at 10.1% and as Gas Supply fears worsen. The market is now expecting BOE to act more aggressively than the Fed with rates expected to rise above 4% by end of Q1 2023. This has seen 2-year GBPUSD swap points drop by more than 200pips into negative territory and in our opinion are at very appealing levels to go long. We expect GBPUSD to consolidate around these levels as sterling support from higher rates offsets the fears of deeper recession in the UK.

US, UK, Italian, Germany, 10yr Yields

Yields remain elevated in the last couple of months as the ECB began to hike rates.



Source: Bloomberg

Technical Analysis

GBPUSD

GBPUSD failed to break above resistance @ 1.2332 and has since reversed and broken below 1.1760 support. On the downside, this could lead further downward move to 1.15 and the low from March 2020 @ 1.1412. With the divergence pattern forming a sustained close below 1.1412 may be difficult. A Sustained close below would open the doors to a deeper correction to 1.10 and then 1985 low of 1.0520. On the upside, resistance is @ 1.23, a close above would lead to further gains up to 1.2683 and white downtrend line.

EURUSD

EURUSD continues to trend lower after failing to climb above the white downtrend line. Another close below Parity this week could \open the doors to further move lower to our next support @ 0.9593 (from 05/2001). On the upside, a break above white trend line could see a larger correction up to 1.0787 and longer term down trendline.

USD Index

USD Index has been trending higher with Green trendline, making a fresh 20 year high. Whilst green trendline remains intact another leg higher is possible. However, momentum appears to be fading after a strong run up, highlighted by the stochastic divergence so there could be change of trend soon. On the upside, a close above 109.14 (76.4% FIB of move from 2001-2008) / 109.25 could lead to further gains up towards next level @ 121.02 On the downside, a close below green uptrend and 105 could pave the way for a deeper correction down to 101.62 with support after that coming at 50% fib line.

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