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The Case for a Euro Base

Parity inevitable, but we are wary of chasing EURUSD further

- Valuations and positioning hitting extremes
- Political and data stabilisation perhaps underappreciated
- Data and rate pivot from non-Eurozone input economies notable

Europe will continue to underperform, but much is in the price

The euro is starting 2025 where it left off in 2024 – under pressure from rising US yields. We believe it is only a matter of time before parity is reached. This is a highly symbolic level which is often considered indicative of dire economic straits for the Eurozone. The last time this level was reached was in Q3 2022, but the supply shocks arising from the Ukraine war and post-pandemic recovery stress can broadly be attributed to exogenous factors. The only period of sustained weakness in the euro below parity was during the early years of the single currency – even during the Eurozone sovereign debt crisis this line in the sand managed to hold. Indeed, the parallels with the euro's early years are perhaps more valid: growth was weak in France and Germany, the fed funds target rate was heading towards the 6-handle and Germany was being referred to as the "sick man of Europe" by the English-speaking press. Under pressure from his G7 peers, then-ECB President Duisenberg acceded to coordinated intervention, which helped put a floor under EURUSD at around 0.82. However, what followed was reform in Germany and the broader EU, which helped reinvigorate competitiveness and growth, allowing EURUSD to almost double to 1.60 at the onset of the global financial crisis. The need for renewal is abundantly clear for the Eurozone and looking ahead to 2025, the risk is that some meaningful change could really happen. EURUSD's performance is increasingly reliant on USD outperformance and sustained US

exceptionalism – consensus views whose corresponding market positioning could prove difficult to extend.

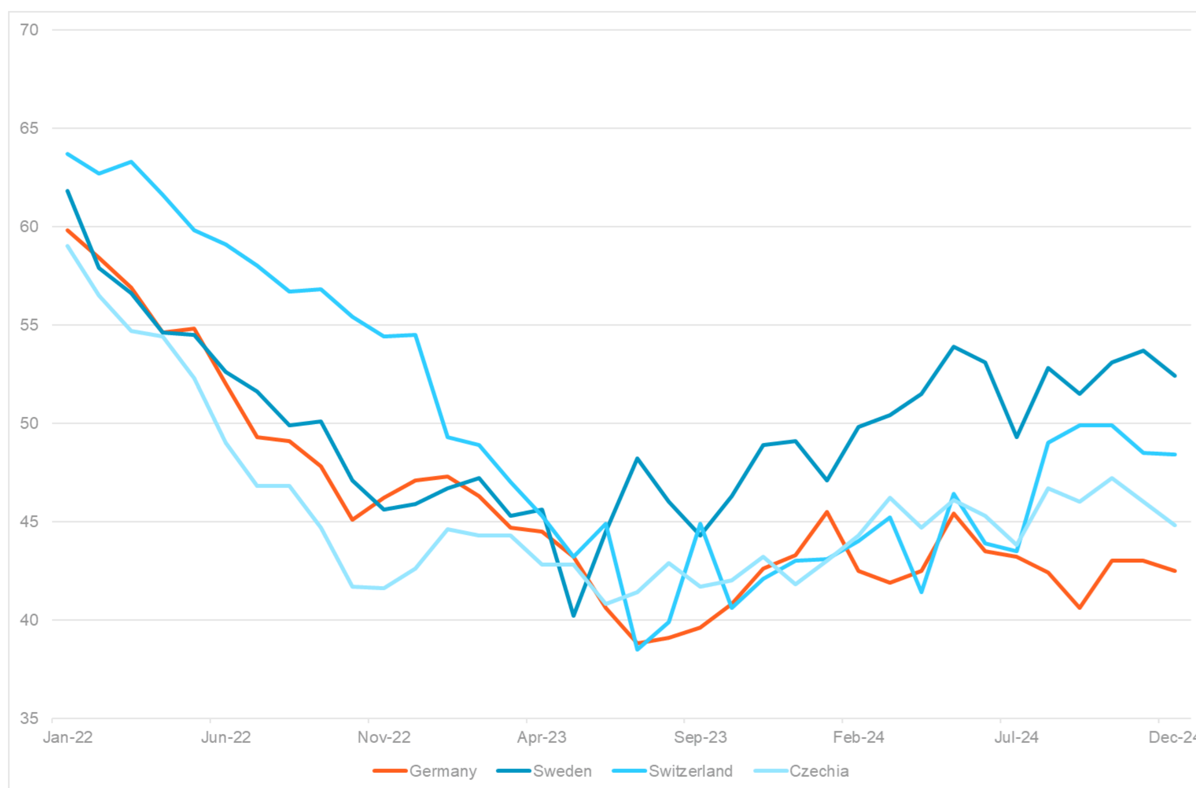
Based on valuations, we acknowledge that the EUR still faces downside risk. EURUSD attracts the bulk of the ECB attention and remains pre-eminent in FX market transactions, but on a trade-weighted basis the EUR is currently at its highs, mostly due to weakness in the currencies of its main trading partners (Exhibit #1). This is a phenomenon that is extending across large markets. For example, USDCNY may have pushed through 7.30 last week but the renminbi index is comfortably higher on the year, due to dollar strength against the likes of the EUR, JPY and KRW – all occupy large weightings in China's total trade. Consequently, it has been difficult for central banks to gauge pass-through impact, but that is precisely the conclusion of the ECB: non-tradables inflation is the crucial driver at present rather than tradables, and the outlook is starting to weaken but not at an aggressive pace. Consequently, there is no need to push for more aggressive easing. Rates markets have ceased to push back against this approach. Unless there are significant downside surprises relative to already downbeat growth forecasts, we no longer see monetary policy as a significant downside risk to the currency. Even if there are adjustments in valuations, it will not be on the EURUSD leg. If anything, EURJPY has much to contribute to further EUR weakness in index terms, and this is potentially an exchange rate development that the European manufacturing economy would more than welcome.

Exhibit #1: EURUSD vs. EUR NEER

Source: Bloomberg, BNY

On manufacturing itself, we are also revisiting our premise that the last two years of contraction in the sector – which Germany itself has acknowledged is becoming structural – can contribute to further weakness in data. External demand remains subject to various constraints, from weak Chinese growth to the prospect of tariffs, but leading indicators do not point to material risk of further deterioration. We fully acknowledge that this is probably because capacity utilisation is already at a bare minimum, but as asset prices rely on marginal changes, scope for data deterioration is close to exhaustion. For example, PMIs for some of Germany's key "input economies" such as Switzerland, Sweden and Czechia (Exhibit #2) have stabilised through H2 2024, and in some cases there was a healthy bounce towards year-end. We fully acknowledge that Sweden aside, these economies' manufacturing sectors are still contracting, but these factors are already in the price, and industrial policy and reforms are in place to counteract the risks.

Exhibit #2: European PMIs Stabilise



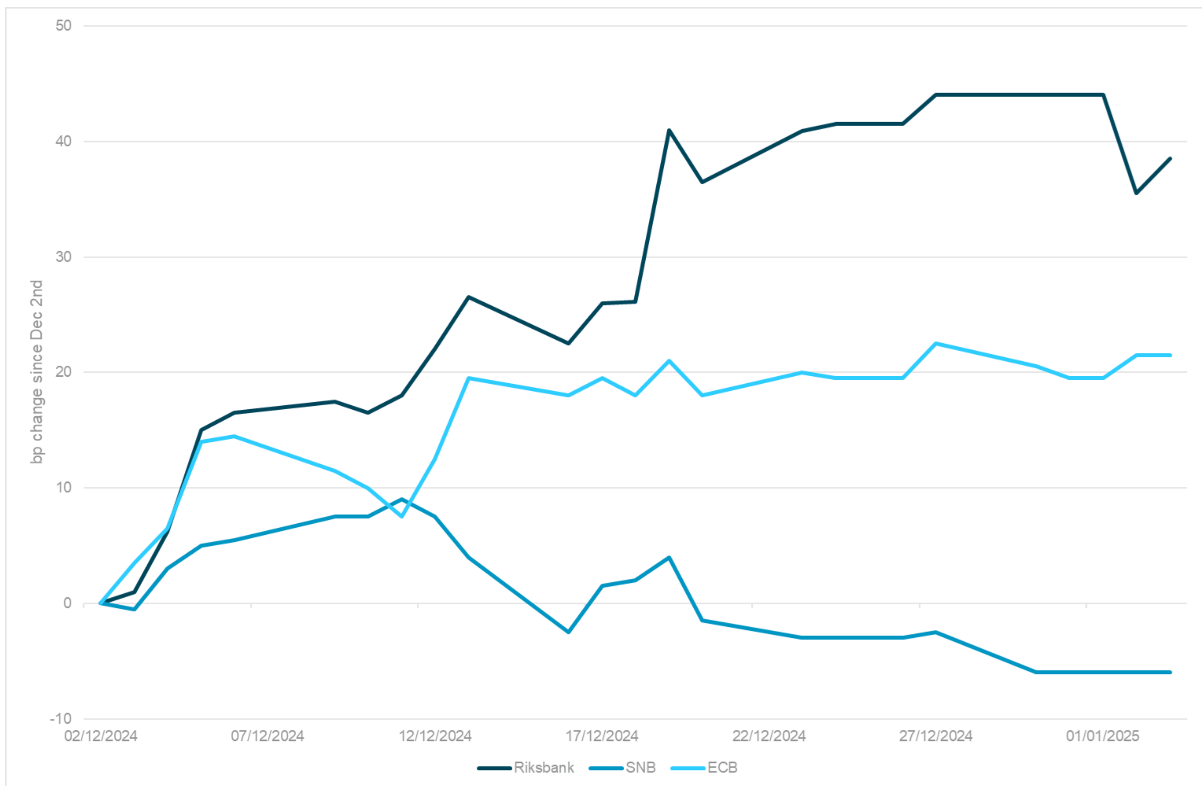
Source: Bloomberg, BNY

Sweden's current situation also requires scrutiny. Throughout much of last year, we felt the ECB was the least dovish compared to the Riksbank and Swiss National Bank. At the time, the Riksbank was surprising the market with very aggressive 50bp cuts while the ECB seemed reluctant to act at all. The SNB was similarly aggressive, and at the time we felt the ECB's Governing Council needed to ask themselves just what their peers in Stockholm and

Bern were seeing that they failed to see. However, the Q4 decisions for these central banks yielded an entirely different outcome. Even though cuts were delivered in line with expectations, both central banks felt that the end to easing cycles was approaching. Last week's Riksbank minutes should create a clear consensus amongst the policy board members that the Swedish economy has turned the corner, and it is time to revisit inflation risk. The SNB similarly adjusted their conditional rate outlook up at the end of the forecast horizon in anticipation of better price outcomes. We can see that end-2025 rate expectations have already started to move (Exhibit #3) in a more favourable manner since December in Sweden and the Eurozone. On a sustained basis, this will help central banks across Europe match the Fed's new outlook, especially if US demand provides an additional tailwind.

It is precisely due to a more favourable policy path and attractive valuations that we see SEK and CHF outperforming this year, despite a weak interest rate profile. However, all European exporters' growth and currency outcomes will depend on limited trade friction with the US and China. Between the EU and the latter, there is scope for a negotiated settlement on electric vehicles and associated green technologies. It is trade relations with the US where risks are more difficult to reflect in asset markets, and we acknowledge that material tariffs against European exports would trigger a response in monetary policy to the Eurozone's detriment. Geopolitics will feature prominently, but national-level politics will no longer face the challenges of 2024, and we anticipate a good mandate for the next German government to unleash reforms akin to the early 2000s, starting with changes to rules governing the debt brake to unleash investment.

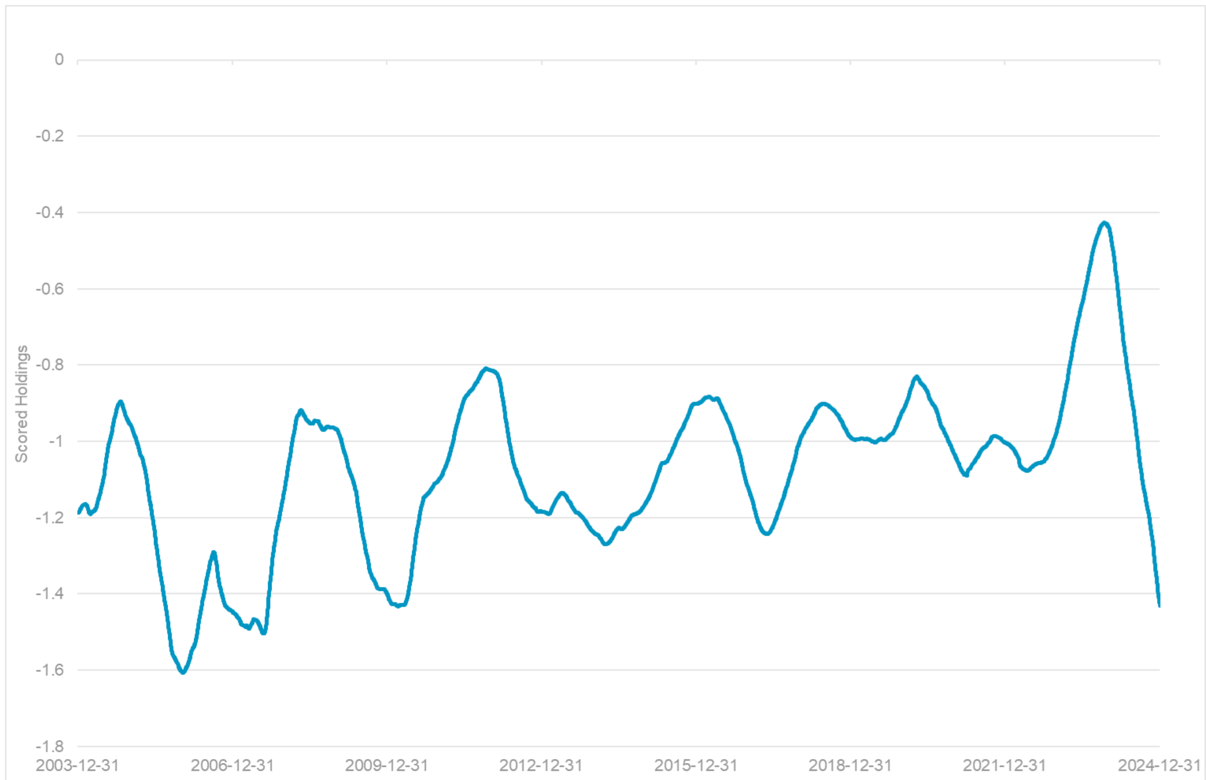
Exhibit #3: Year-end Bounce in Rate Expectations



Source: Bloomberg, BNY

Finally, we believe one of the biggest obstacles to further EUR weakness is the simple fact that there might not be much left to sell in risk terms. Our custody data indicate that on a cross-border basis, underheld positions in the euro (Exhibit #4) are at their most extreme levels in two decades, which reflects the wide rate differentials and US exceptionalism theme which incentivizes very active hedging of Eurozone exposures by USD-based investors. Furthermore, we note that total holdings in euros, based on our data, are now fully flat for the first time since 2022. Unlike that period, Eurozone investors are not actively reducing their hedges of overseas exposures. Even so, the qualitative change in market position requires careful risk management. We don't see a flip to euros moving back towards overheld soon, not least due to our view on USD rates. However, the case for the EUR (or at least EURUSD) finding a base in the next quarter is becoming more compelling from the key inputs.

Exhibit #4: EUR Cross-border Holdings



Source: BNY

Please direct questions or comments to: iflow@bny.com

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