Upside potential for the dollar and sterling versus the euro

The action in some of the key currency pairs for much of the summer has been confined to fairly tight ranges. The EUR/USD rate has, for the most part, traded in a compressed $1.17-1.19 corridor since mid-year. Meanwhile, EUR/GBP has spent most of this timeframe in a narrow 85-87p band, with a brief period below the 85p level to a low of 84.5p earlier this month.

The relatively compact trading ranges are against a backdrop of all the main economies experiencing a rebound in growth amid an easing of Covid-19 restrictions, while their respective central banks have been maintaining expansionary monetary policy settings. However, at some point, over the coming quarters, we could start to see more noteworthy action amongst some of these forex pairs.

A key point of focus in this regard will be monetary policy. Interest rates are a crucial factor behind currency market dynamics. Their stability has been an important influence on the narrow trading ranges over the past year.

From the perspective of the dollar, rate hikes are quite possible in the US next year. In contrast from a euro viewpoint, Eurozone rates look set to stay on hold for a long time. Futures contracts indicate that the market expects that it could be 2024 before the deposit rate is increased from its current level of -0.5% and Eurozone rates could still be in negative territory at the end of 2026. A widening of interest rate differentials, if it were to materialise next year, should be supportive of the dollar.

Indeed, of the limited action to register over the summer, within the aforementioned narrow trading ranges, the tendency has been for the euro to edge lower. This is reflective of the view that Eurozone interest rates will remain decidedly negative over the next few years. In the shorter term, the dollar may be supported by the tapering of asset purchases that is envisaged by the Fed later this year, given that the ECB is expected to continue with the large scale buying of bonds for the next couple of years.

One potential downside for the dollar though, could be a sustained rise in US inflation relative to elsewhere. Though US rates would have to rise, high inflation is usually a forerunner for currency weakness. Another possible headwind for the dollar may be if vaccine hesitancy results in continuing high Covid-19 infection numbers and hospitalisations in the US, restraining the pace of the economic recovery and delaying hikes in interest rates.

At the same time though, it is difficult to pinpoint any significant upside potential for the euro, given the outlook for Eurozone interest rates. On top of this, there is some looming political uncertainty from elections in Germany and France, this year and next, which may weigh on the currency. Thus, the balance of risk points to some upside potential for the dollar against the euro.

Elsewhere, it is not easy to foretell the next major move in sterling. Market positioning is relatively neutral. The UK economy is performing quite well suggesting the currency should remain underpinned after its very solid performance in recent months. Further out, if rate hikes materialise in the UK next year as markets expect, it could provide a fillip for sterling, especially against currencies with zero or negative interest rates like the euro.

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