Economist's Weekly Market View

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Euro weakens as Brexit weighing on UK recovery

Expectations in regard to interest rates are having a perceptible impact on currency markets. The dollar, in particular, has been on a rising trend since mid-year in the context of the US Federal upping its projections on interest rates.

The current median projection from the Fed is that US rates will start to be hiked from their present level of 0.125% before end 2022, getting to 1% by end 2023 and 1.75% at end 2024. Up until June, the Fed was of the view that there would be no increase in rates out to end 2023. Markets are even more aggressive, looking for two 25bps hikes in 2022 and three more the following year, taking rates to 1.375% by end 2023.

Interest rate futures contracts have hardened somewhat in the Eurozone also, but nothing like to the same extent as in the US. Furthermore, while the market has been looking for euro rates to start rising by end 2022, the ECB is pouring cold water on the notion.

It believes that the current spike higher in prices will prove transitory, and inflation will fall back below target in the next couple of years, suggesting rate tightening will not be required. This softer approach from the ECB has seen the euro come under pressure against the dollar. The EUR/USD rate has fallen from $1.22 in early June to below $1.13 in recent days.

Interest rates driving currency movements is nothing new in forex markets. The dollar appreciated very sharply between 2014 and 2016 and stayed at elevated levels over the rest of the decade, underpinned by relatively high US interest rates.

However, it moved steadily lower in the final three quarters of 2020, losing 12% against the other major currencies, as US rates were cut to virtually zero. Eurozone rates remained unchanged so the euro rose last year on the back of a favourable move in interest rate differentials.

More recently, sterling has benefitted from signals by the Bank of England that UK rate hikes are on the cards, sooner rather than later. The market now expects 100bps of rate tightening in the UK before end 2022. This has seen the euro fall from 86.5p at end September to around the 84p level more recently.

A key question is, will the slide in the euro continue? Rate hikes seem likely very soon in the UK, which should be supportive of sterling. However, the 83p level is a major support level for the euro, which has not been overcome by sterling since the Brexit referendum in 2016. This support level may continue to hold, even with rate hikes, given the UK is lagging behind other countries in terms of its economic performance during 2020-21.

Meanwhile, against the dollar, there is considerable support for the euro in the $1.10-1.13 range. Beyond that, the $1.08 level offers very strong support, which most notably held in early 2020. Indeed, one has to go back to 2015-2016 for the last time the pair spent any time below the $1.08 level.

Overall then, as we move into next year and the Fed gets nearer to the point of hiking rates, this could bring more downward pressure to bear on the EUR/USD rate. However, a very sharp fall from here in the pair seems unlikely.

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