31.10.2023

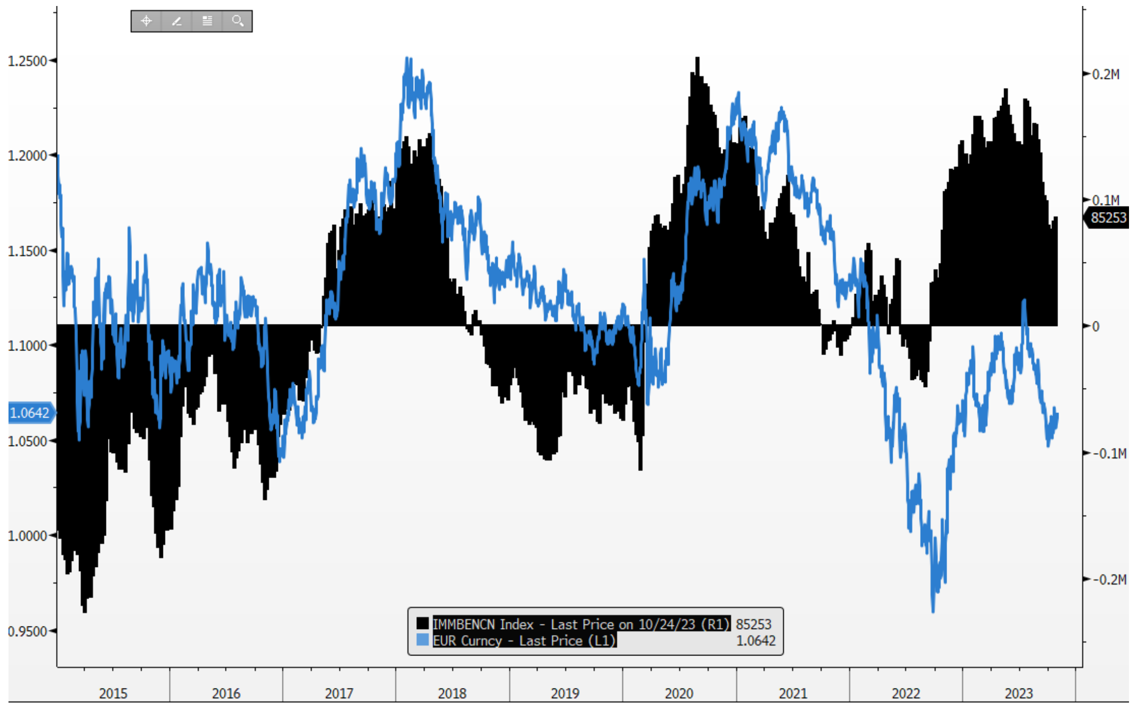
What's going on with the Euro?

Recent data has only added to the narrative that contrasts a resilient US economy with the fragility of the Euro Zone.

As a result of weak growth and sizeable falls in inflation, markets now price the first ECB rate cut in April next year. In the US the first rate cut isn't priced until July.

The typical investment conclusion is that combination points to lower European equities, bond yields and single currency.

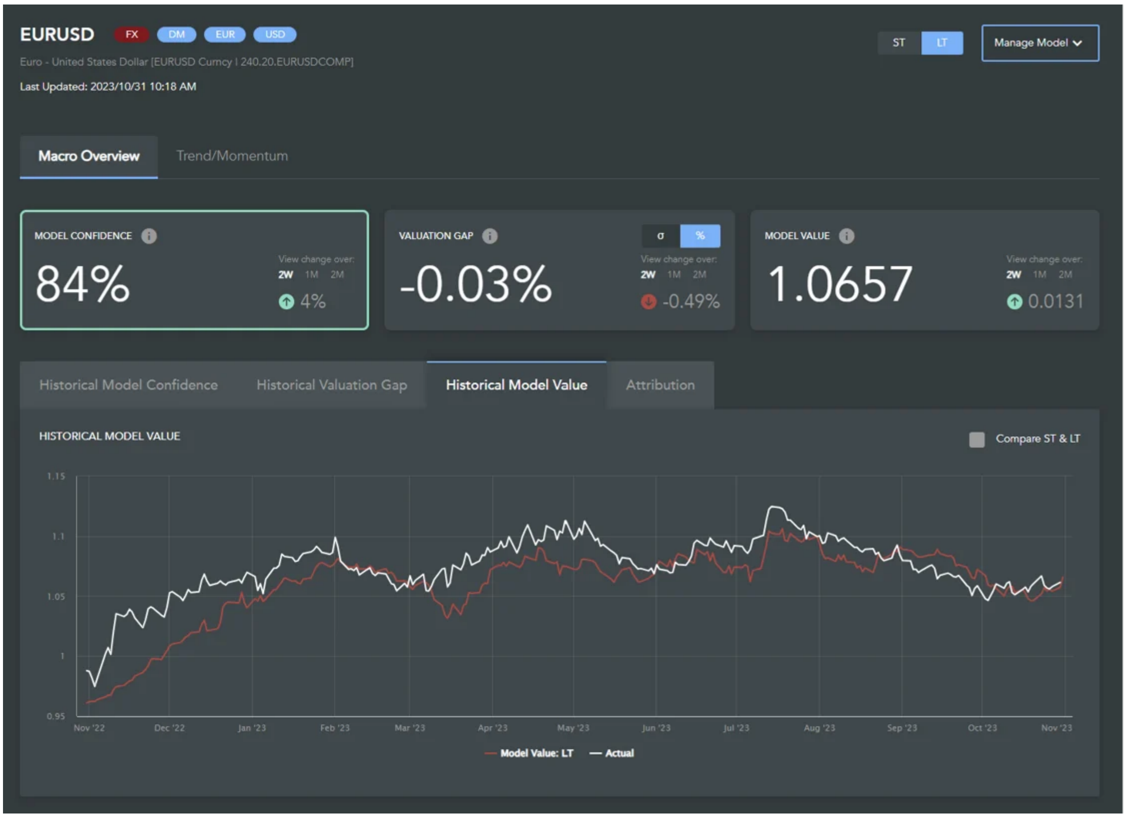
Indeed, the latest CFTC snapshot shows spec's net long position in the Euro has more than halved in the last two months.



But the Euro has quietly rallied almost 2% in October. That would appear to contradict the narrative about comparatively weak European growth. It's also taken place against a backdrop of US nominal yields moving higher than their European equivalent.

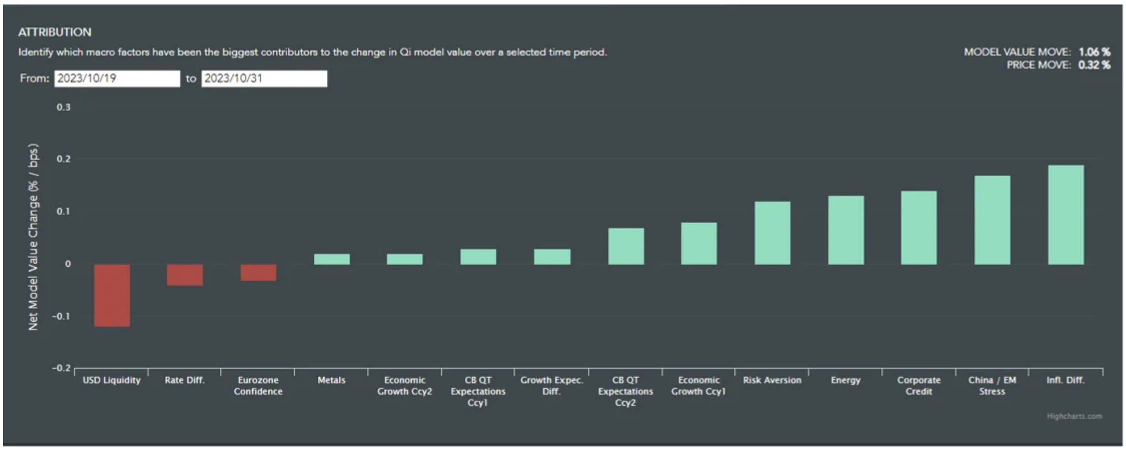
So what is driving things?

When we look at Qi model value for [EURUSD] we can see it bottomed at 1.0463 on Oct 19th and has subsequently bounced almost two big figures.



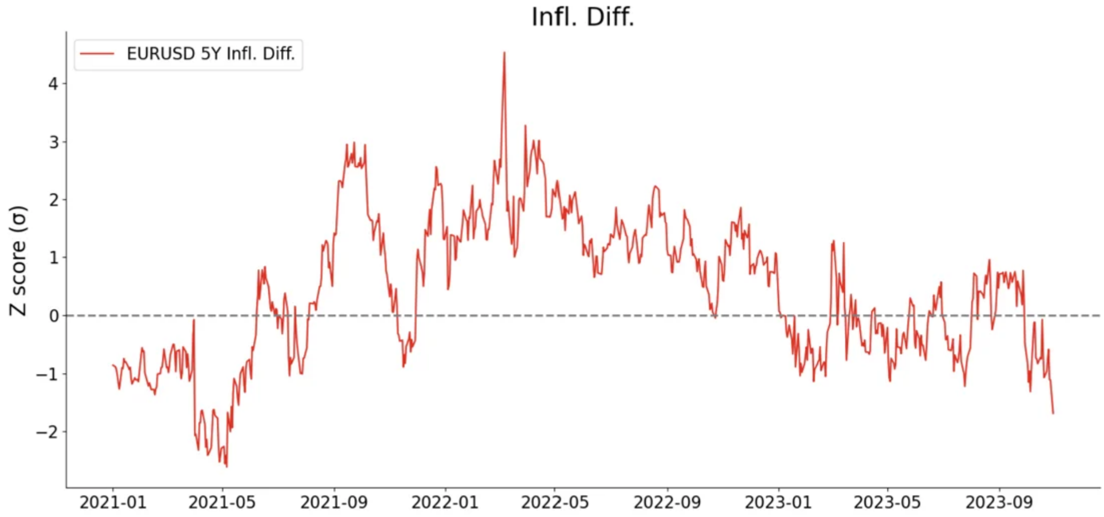
The biggest driver of that move?

Partly that the initial "risk off" move - credit spreads and China stress - hasn't gotten any worse. But the main push behind macro model value has come from relative **inflation expectations.**



The chart below shows the difference in European and US 5y inflation expectations in z-score terms. EU inflation expectations are now almost 2 standard deviations below trend versus their US equivalent.

The market is starting to price a hard landing in Europe.



Now at some point that **disinflationary scenario** will probably become a **headwind for the Euro**. Similarly a renewed surge in US nominal yields or credit spreads legging wider both have the power to shift macro momentum once again.

But the recent pattern suggests **real yields have mattered more** and are currently favouring higher EURUSD.

There is no valuation edge - spot is trading in line with macro conditions - but a good example of how important it is to understand exactly what it is driving markets.

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