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Financial Markets Research Team**Nick.kounis@nl.abnamro.com**

Tel: +31 20 343 5616

nick.kounis@nl.abnamro.com

How far will the euro rally go?

Global FX: Euro will struggle to move higher from here – Since 10 April 2017 the euro has rallied substantially. EUR/USD has risen by 11.5%, EUR/JPY by 11%, EUR/CHF by 7.5% and EUR/GBP by 6%. The rally in EUR/USD has been driven by a combination of euro strength and some US dollar weakness. On the one hand, EUR/USD has rallied in line with a narrowing yield spread (nominal and real yields) between the US and Germany. This mainly reflects expectations on the monetary policy front on both sides of the Atlantic. Indeed, investors remain sceptical that the Fed will raise interest rates much further given subdued core inflation. At the same time, ECB QE tapering expectations have built. On the other hand, sentiment towards the US has deteriorated because weaker than expected US economic data. Moreover, political uncertainty in the US increased, while it eased in the eurozone.

We expect that the euro rally will run out of steam in the near term. For a start, we expect ECB President Mario Draghi to dampen expectations about early rate hikes. The ECB is concerned that tapering will trigger a tightening of financial conditions and seems focused on tapering without triggering a tantrum. Moreover, recently the yield spread between the US and Germany has widened a bit again, while EUR/USD has continued to be strong. We think that the yield spreads (nominal and real yields) do not justify EUR/USD being at current levels. Therefore, we think that that EUR/USD has overshot.

Furthermore, we expect sentiment towards the US to improve somewhat, which should result in the US dollar reacting positively to better than expected US economic data again such as last Friday. A lot of US political risk already seems to be priced into the dollar. Finally, we think that the investor positioning is currently stretched. The euro net-long speculative positions in the futures market are at excessive levels and the upside bias in EUR/USD in the FX options market is somewhat expensive. Therefore, it is likely that EUR/USD will struggle to move higher from here. If speculators experience that the upside in EUR/USD is limited, they will probably take profit on long euro positions, resulting in a lower euro across the board. Then a move towards 1.17 or even 1.15 is likely in EUR/USD. However, any profit taking in EUR/USD is in our view only a correction and not a new US dollar rally meaning that we expect a higher euro further down the road (Georgette Boele).

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ABN AMRO Bank
Gustav Mahlerlaan 10 (visiting address)
P.O. Box 283
1000 EA Amsterdam
The Netherlands

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