Sucden Financial

FX Monthly Report- Euro Focus

December 2024

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Euro Focus

The EURUSD pair has been under significant selling pressure in recent weeks, driven by an increasingly divergent economic trajectory between the European and US economies. This divergence, compounded by growing political and fiscal uncertainties, is creating additional challenges for central banks in both regions as they grapple with the fast-changing economic environment. With budget issues in France and Germany, along with Trump assuming office in January, what is the outlook for EUR/USD in the coming months?

Political Landscape

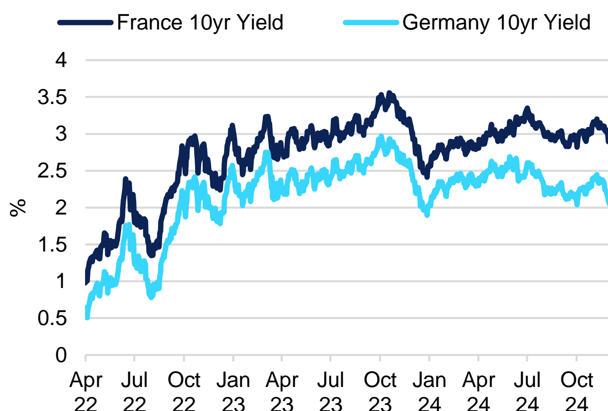
Internal – France and Germany Budget Crises

From a political perspective, the European economy is facing mounting pressures on both internal and external fronts.

Internally, bubbling budget crises are becoming more apparent across the bloc, with the largest economies, notably France and Germany, bearing the brunt of the challenges. In particular, the euro has experienced a notable decline against the US dollar, exacerbated by political turmoil in France, which faced a no-confidence vote over budget disagreements. The outcome brought the country to a government collapse, pushing the country one step closer to the possibility of a far-right administration – the very scenario Macron sought to avoid earlier this year. As a result, French bond yields briefly surpassed those of Greece, with the spread against German Bunds widening to 80 basis points. This prompted a sell-off in French assets, further intensifying pressure on the EUR's performance.

French and German 10-year Yields

Both French and German bond yields weakened in recent days, following a risk premium drop after political instability.

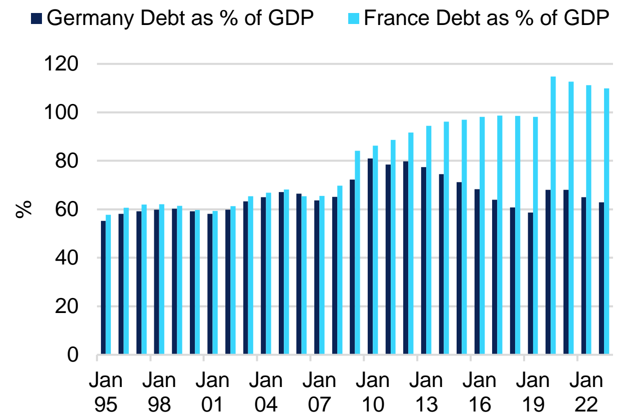


Source: Bloomberg

In an effort to ensure stability, a new Prime Minister is expected to be elected as soon as possible. However, recent events underscore the challenges France must confront, particularly public debt. Despite potential government changes, budget decisions will remain complex until the legislative elections in June 2025, further complicating France's issues. As a result, the risk associated with France is likely to remain high, sustaining a higher risk premium in the country. In the meantime, the spreads between French bonds and Bunds should continue to widen.

Germany's and French Debt as % of GDP

French debt has breached 100% threshold in 2020, creating raising concerns about fiscal sustainability in the coming years.



Source: Deutsche Bundesbank, Eurostat

Germany is also facing fiscal issues, culminating in the announcement of a snap election scheduled for February 2025. This follows the government's refusal to suspend the constitutional borrowing limit, which caps structural deficits at 0.35% of GDP. We do not expect that a single party will secure a strong majority, given Germany's increasingly fragmented political landscape. Moreover, even if one party does manage to gain a lead, the precedent set after the 2021 election – when it took Olaf Scholz over two months to form a coalition—suggests that forming a stable government will be a protracted process. Conservative chancellor candidate Friedrich Merz said he is open to reforming Germany's strict borrowing limits as long as additional debt-financed spending is used for investment. This signals that Germany's fiscal challenges are likely to persist into the first half of 2025, further compounding the economic and political uncertainty.

These economies are confronting significant fiscal challenges that could persist well into the future. In France, the mounting debt and persistent deficits may lead to increased borrowing costs and potential credit rating downgrades. Meanwhile, Germany's strict fiscal policies, coupled with sluggish economic growth, could pose a threat to long-term growth prospects. These issues, combined with growing political instability, have amplified investor anxiety, fuelling demand for euro depreciation.

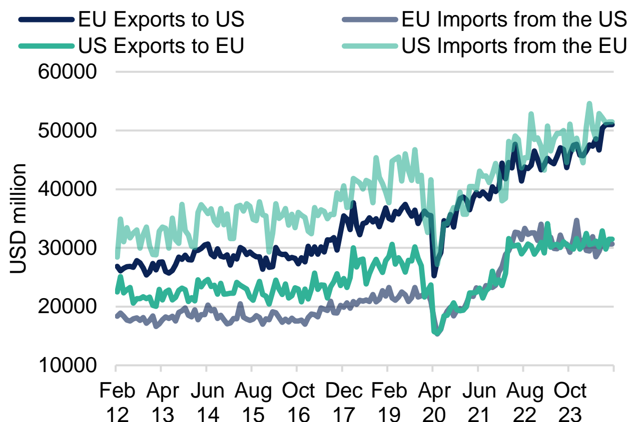
External – Trump's Tariff Implications

With Trump winning the US presidential elections in November, speculations are growing around the potential for a more inflationary economic agenda in the US. This could reduce the urgency for the Fed to cut rates as aggressively or quickly as the ECB, further widening the yield differential between the two economies.

Moreover, Trump's well-known tariff policies from his previous term are raising concerns that he may impose further tariffs in the near year. With the Biden administration maintaining the existing tariff levels set by Trump, any new round of tariff increases could further damage relationships with other countries and create supply chain bottlenecks. Although Trump has not yet clearly outlined his trade intentions toward the Eurozone as he did with China, Canada, and Mexico, markets are on edge, pricing in the scale and timing of tariff implementation towards the Eurozone.

Trade between US and EU

In the past four years, both the US and EU have significantly increased their share of exports to each other.



Source: Eurostat, US Census Bureau

Proposed universal tariffs of 10% to 20% on all imports into the US could make European exports more expensive and less competitive. The EU's automotive industry, in particular, is highly vulnerable due to its substantial exports to the US. Agricultural exports, along with industrial goods, could also face tariff impacts that would significantly affect the EU's trade outlook. As a result, many European economies are already shifting resources abroad to avoid potential supply chain disruptions, leading to a large outflow of capital.

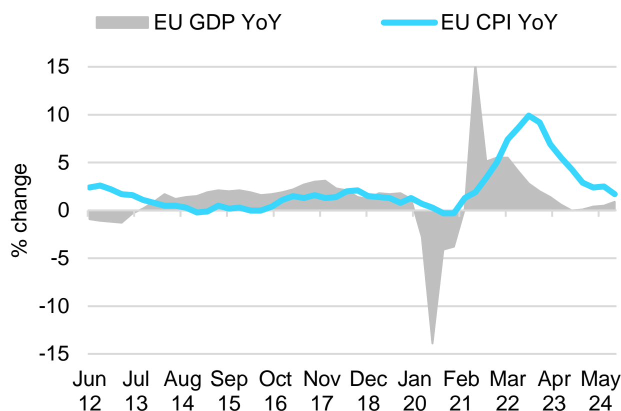
As a result, with the increased need to hedge against Trump's tariffs, the dollar is likely to remain elevated in the near term.

Economic Landscape

From the economic perspective, the euro's outlook remains fragile, with market participants closely monitoring upcoming economic data releases, including inflation figures and GDP data. While the reduction in inflation is a positive development, the EU's economic growth remains modest. Lately, the Eurozone's economic outlook has been further clouded by disappointing PMI figures, showing contraction in both the manufacturing and services sectors. These factors contribute to the current bearish sentiment surrounding the EU.

EU GDP vs CPI YoY Change

While inflationary pressures are easing, the GDP growth in the bloc remains muted.



Source: Eurostat

These factors are contributing to a widening the yield gap between US and Eurozone bonds, with US Treasury yields remaining elevated on the back of strong economic data. The divergence in monetary policy expectations has kept the euro under sustained pressure while the US dollar continues to benefit from its safe-haven currency. Although we anticipate both the ECB and the Fed to cut by 25bps in December, the perception of a less dovish longer-term narrative from the Fed is likely to exacerbate the yield differential with the ECB. This should continue to weigh on the euro going into 2025.

Despite these challenges, we believe that the euro's decline at 1.04 may be overstated, as markets appear to have already priced in the world of the political and monetary policy outlook at this level. However, ongoing political uncertainty and persistent economic headwinds in Europe suggest that the euro may continue to remain under pressure in the near term. We believe that EURUSD will continue to be driven by the relative economic performance of the EU versus the US. As of now, there is little to suggest that European performance will improve meaningfully in comparison to that of the US, further constraining the euro's recovery potential.

Desk Comments

GBP

The UK's growth outlook has been weakening. The private sector has shifted from growth to stagnation following the budget announcement, which received a negative response from markets to the fiscal plans outlined by Chancellor Rachel Reeves. Additionally, PMI figures have hit their lowest levels this year, with the composite PMI declining to 49.9 from 51.8, falling below the threshold that signals economic contraction. This development is likely to concern the Labour government, compounding an already declining confidence in the administration. This sentiment is reflected in a petition garnering sufficient support to demand an immediate general election.

Pay growth and services inflation, key indicators of underlying domestic price pressures, remain in focus. Despite a tight labour market, the future interest rate path hinges on incoming data. A gradual easing trajectory suggests that a rate cut in December is unlikely, with February being a more plausible option as further evidence of disinflation is awaited. The situation underscores the need for more data to assess potential inflationary impacts, while external factors, such as Donald Trump and budget implications, remain under observation.

Currently, market expectations for rate cuts in the UK are modest, with only three cuts priced in by September next year, compared to six for the ECB. However, a potential re-pricing of global central bank policies could significantly impact the UK yield curve. This could exert downward pressure on the GBP, both against the USD and in cross-currency pairs so we prefer to fade GBP rallies.

EUR

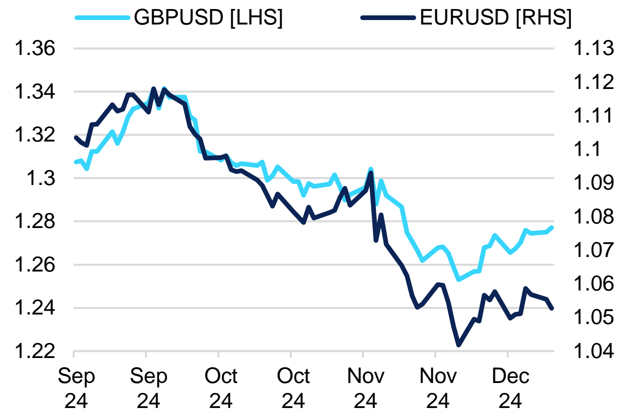
Over the past month in the Eurozone, following Trump's election in the US election the focus within the region has returned to political driven uncertainty particularly in France and Germany. In France PM Barnier was forced to resign following a vote of no confidence, leading to Macron once again having to focus on finding a candidate to become the new PM, However a new parliament isn't expected to be formed until the new year which has helped cast an economical shadow of uncertainty over the Eurozone as without the newly formed Government France won't be able to produce its 2025 budget in time for the new year.

In Germany, following a similar vote of no confidence in the newly elected government Chancellor Scholz has agreed to move the snap election forward to the 23rd of February which will effectively scrap the 2025 budget which the new government had passed and force Germany to roll over the 2024 budget into the new year until a new government is formed.

There is a strong expectation of a 25-basis point rate cut at the ECB meeting in December as It appears that any shift away from a dovish stance will not provide substantial support to the euro moving forward. With the above-mentioned political uncertainty in both France and Germany there may be a need for the ECB to be more supportive in their monetary policy. Adding to the bearish EUR outlook could be the impending US tariffs, with Trump threatening to impose tariffs on European cars and auto parts two of the key eurozone industries, particularly in Germany. The growth outlook for Q4 has remained rather bleak with November PMIs declining further. The composite index fell to 48.3 (previous: 50.0, cons: 50.0), mainly due to a drop in services. The decline was widespread across countries, with Germany and in particular France standing out as contractionary trends continued.

GBP and EUR vs the Dollar

EUR and GBP have been under significant selling pressure.



Source: Bloomberg

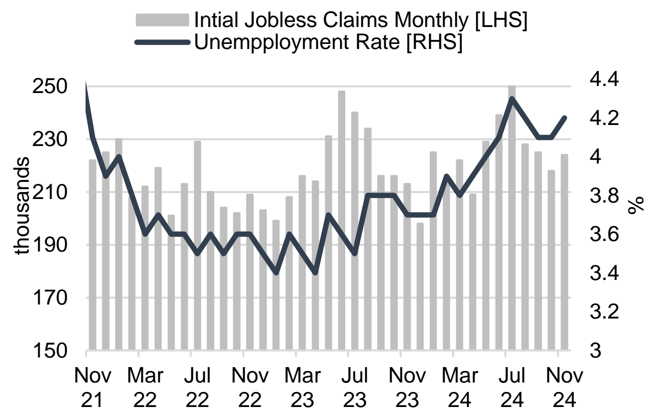
USD

The direction of the USD continues to be influenced by market dynamics associated with policies and sentiments tied to the impending Trump administration. Headlines suggest that Trump is keen to push forward with pre-election threats of tariffs so a tit-for-tat escalation on tariffs could ensue. The Trump trade is starting to get built into the price as risk premium and implied vol is on yearly highs, but we are still far from pricing a full global trade war.

Trump has appointed Scott Bessent as Treasury Secretary, a move that the market perceives as a more balanced and pragmatic choice. Bessent is regarded as a reliable figure, with his proposed "3/3/3" policy—reducing the budget deficit to 3%, aiming for 3% GDP growth, and increasing oil production by 3 million barrels per day—viewed as a more fiscally disciplined approach than what bond markets had anticipated.

US Initial Jobless Claims vs Unemployment Rate

Recent labour market data indicates a moderate decline in activity over the past few months.



Source: Bureau of Labour Statistics, Department of Labour

Bessent's approach should help when it comes to key issues, such as tariffs, where business leaders are most apprehensive about Trump's economic policy. He expressed strong support for tariffs but says they must be targeted, selective and carefully executed. In addition, we have noted positive seasonality for risk assets in December, it is perhaps unsurprising that USD has declined this month. We think there is potential for further dollar correction into year-end as the FED needn't be this restrictive.

This view is further supported by the labour release earlier this month. The unemployment rate, less affected by one-offs, after the weather disruptions crept up to 4.2% in November. The uptick in the unemployment rate supports the call for a 25bp cut at next week's meeting. After release of NFP chance of 25bp cut went from 65 – 90 % so 0.22 bp priced in.

EURUSD Outlook

Our View: We expect downside pressures to ease into the year-end, with 1.03 holding firm . However, the return to 1.08 is unlikely. This is due to the combination of a weaker economic landscape of the EU compared to the US, which could prompt the ECB to implement more aggressive cuts. Additionally, the anticipation of Trump's tariff policies starting in 2025 is contributing to this softness. Meanwhile, the strength of the US dollar is expected to continue, supported by robust economic fundamentals and geopolitical uncertainties that favour safe-haven flows.

Technical Analysis

GBPUSD

GBPUSD retraced to the 200-day moving average, a level we highlighted as offering an improved risk/reward ratio for GBPUSD short positions. To the upside further resistance is the 50% retracement 1.2960 then previous cluster resistance at 1.3050. If these levels hold and USD resumes its recent strength then 1.2487 previous low and if broken further downside to 1.2300. We anticipate limited volatility for the remainder of the year but could see a retest of the lows in Q1.

EURUSD

EUR/USD has broken through the trendline resistance at 1.0760. The strength of the USD continued as more risk premium has been priced in the market for a Trump administration. The pair failed to close below the 50% Fibonacci retracement support level at 1.0405 and has retraced close to previous lows at 1.0610. This is a more favourable risk/reward opportunity to sell EURUSD but we are mindful of USD seasonality in December and a further move higher. Resistance is now positioned at the trendline and previous highs around the 200-day moving average, between 1.0935 and 1.0960.

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