Improving Eurozone Data Point to Strengthening EUR

With Brexit risks and sluggish growth limiting EUR upside, the common currency has failed to catch the market's wave against the greenback which began as last summer came to an end; the EUR's gains over the last three and a half months fall within the bottom third of all major currencies. We believe, however, that the EUR is poised to appreciate steadily through the course of the year as markets lift the currency closer to its long-run fundamentals and as major uncertainties dissipate. We estimate that EURUSD should be trading at 1.14 currently based on its long-run fundamental drivers while we expect the currency to close out 2020 at 1.16. Positive Eurozone data surprises should start to have a more positive impact on the exchange rate.

Eurozone data have for the most part exceeded expectations from the fourth quarter onward, particularly in the bloc's growth engine Germany—which is the most susceptible to declines in global trade volumes from the US-China trade war and Britain's morose expansion (excl. Ireland). Yet, despite the better-than-expected soft and hard data readings out of the bloc, markets maintain a cautious view of the EUR, particularly as Brexit risks linger and as economists remain reticent to update their expectations for growth in the eurozone this year. In fact, despite data surprising to the upside since October—especially when compared to US data—the EUR has failed to make much ground; within the context of broad-based USD weakness, the common currency's performance is particularly disappointing.

German ZEW survey figures and Markit PMI readings for Germany, as well as for France and the Eurozone, out next week for January are expected to reinforce the idea that the bloc's economy is on an upswing following its weakest period of growth in H2-19 since the double-dip recession. Next week's data run may prove pivotal for the EUR; consensus estimates for these data seem conservative at the moment, in our opinion, based on evidence from other leading indicators.

In the minutes to its Dec meeting, ECB participants discussed the possibility that the positive impact from its latest policy actions—a new asset purchase programme, a deposit rate cut, and the introduction of a 'tiering' system for bank reserves—on the eurozone economy may have been underestimated. The bank's latest forecasts call for Eurozone real GDP to expand by only 1.1% in 2020 while professional forecasters are projecting a 1.0% expansion; recent data suggest that the economic rebound may occur at a faster pace than anticipated which should result in greater inflows into EUR-denominated assets, driving the currency higher.

The ECB is also set to confirm its "monitoring" approach at its policy announcement next Thursday, fully extinguishing the possibility of additional stimulus with the economy generally evolving in line with policymakers' expectations. ECB speakers have also consistently pressed for greater public spending to counteract the economic slowdown, particularly by the likes of Germany and the Netherlands who retain favourable budgetary conditions. President Lagarde will also present a blueprint for the ECB's year-long strategic review, with the Bank's price stability target the main focus as policymakers consider a move away from the current (and elusive) "below, but close to, 2%" target.

Market conditions may be evolving to a point where positive Eurozone data surprises could elicit a more positive response from the EUR itself. Investors have been slowly paring long USD positions against the major currencies in recent weeks but IMM data suggest that speculative accounts retain a significant net short EUR position (of 48k contracts, according to last Friday's data). We think longer run technical signals are also turning more favorably for the EUR after positive developments on the weekly/month charts late last year. New, short term cycle highs, above the late-December peak of 1.1239, should put spot on course for a test of the low 1.13s.

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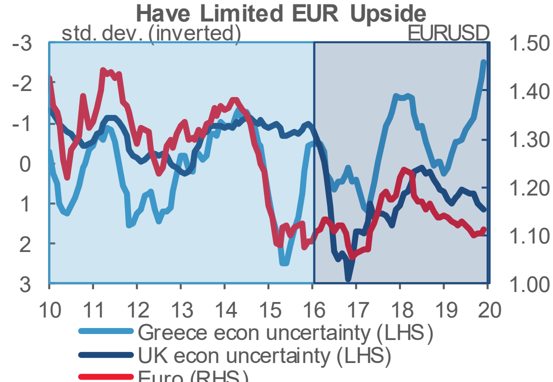
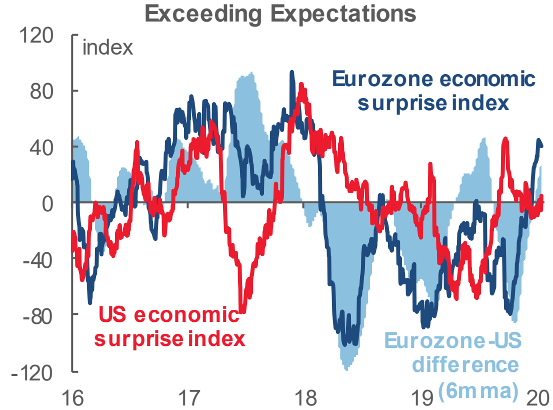
European Debt Crisis and Brexit Have Limited EUR Upside



Source: Bloomberg, Policy Uncertainty, Scotiabank FICC Strategy.

Eurozone Economic Data Exceeding Expectations

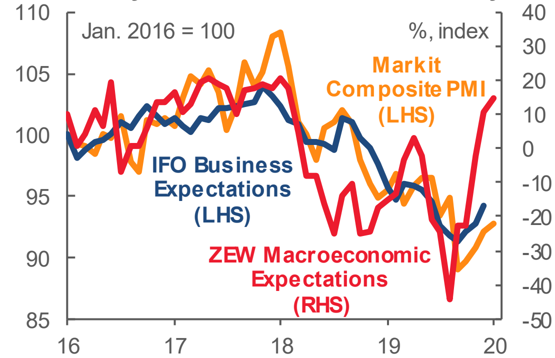


Source: Bloomberg, Scotiabank FICC Strategy.

Eurozone Growth Forecasts Set to Improve?

Source: Bloomberg, Scotiabank FICC Strategy.

Surveys Point to Rebound in Germany



Source: ZEW, IFO, Markit, Scotiabank FICC Strategy.
* Jan ZEW and PMI are Bloomberg consensus.

Asymmetric Response in Growth Forecasts to Economic Surprises

Source: Bloomberg, Scotiabank FICC Strategy.

Improving Global Sentiment Bodes Well for German Economy

Source: ZEW, Sentix, Scotiabank FICC Strategy.