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The euro: reaction versus response

Ever made a snap judgement - about a market move, a headline, or a person - only to realise, with a little distance, how wrong your first instinct was? Financial markets are no different. They react first, but it's the more considered response that ultimately shapes prices.

The euro is a case in point. It might have gone up this week but what about the next few months?

Any notion that tariffs were "last year's story" has been abruptly overturned by US threats of fresh measures on eight European allies. This time the flashpoint is Greenland. As markets scramble to react, the immediate question is what this means for risk sentiment, and more importantly, does this herald the start of a reversal of the euro's recent strength shown in our chart?.

Historically, episodes of rising geopolitical uncertainty favour the US dollar over Europe through short-term safe-haven flows. But a threatened 10% tariff tied to territory rather than trade feels a world away from the menace of 100%-plus tariffs for China in April 2025. What happens next to the euro? The considered response depends on whether retaliation and escalation follow - something that will unfold over weeks, not hours.

Source: Bloomberg. Five day moving averages for bond spread and currency.

So far, the euro has been remarkably resilient. It has held on to gains made since the start of 2025, trading broadly in a 1.15-1.19 range against the dollar over the past six months - around ten big figures above its level at the beginning of last year.

The chart tells an important part of the story. On the right-hand axis is the euro/dollar currency. On the left is the five-year US Treasury-German Bund yield spread, chosen as a proxy for relative monetary policy and underlying growth expectations. To understand whether the euro can break out of its range, it’s worth stepping back and considering four drivers: rate differentials, geopolitics, trade, and positioning.

Rate differentials

A stronger euro has been loosely associated with a narrowing Treasury-Bund spread. There’s no claim of causality, but it does suggest that part of the euro’s strength reflects shifting rate expectations - a kind of relative growth model. Our rule of thumb is that up to half of the euro’s movement can is associated with yield differentials, which goes a long way to explaining why FX analysts take a lead from the bond markets.

The consensus view is that US yields rise relative to those in the euro area but of course the spread could also widen with a relative fall in European yields, or a combination of the two. That would reverse last year’s trend and, in our framework, point to a weaker euro. Then there is the possibility of “weaponising” the trillions of dollars of US assets held in Europe, which would also be consistent with that outcome. Today a Danish pension fund said it would be selling US bonds.

Interest-rate parity theory, imperfect though it is, argues there’s no free lunch. The intuition that high rates support a currency tends to hold at very short maturities and in carry trades. The more considered view, consistent with the theory, is that higher yields/falling prices on bonds mean that if there is a loss on the asset, it will be offset by gains in the currency. So relatively higher US yields should mean a stronger dollar and weaker euro, all else equal.

Geopolitics

The world feels more unpredictable - and more dangerous - than it did a few years ago. The reflex is to expect flight-to-quality flows that boost the dollar at the expense of other currencies. Yet recent experience shows how misleading that gut reaction can be. Think of the relatively muted market response to the focus on Iran and Venezuela earlier this year.

The dollar’s performance has been shaped less by classic haven flows and more by countervailing forces: diversification into alternatives like gold, and renewed debate about the dollar’s long-term reserve status. That helps explain why the euro has held up better than instinct alone might suggest.

There is more.

Trade

Tariffs affect terms of trade and, ultimately, exchange rates. Last April's threatened 100% and more tariffs on China illustrated how trade and geopolitics are now inseparable. Yet China's trade surplus has grown since tariffs were introduced, defying expectations.

From the Chinese economy's perspective, diversification away from US markets, the strength of manufacturing, other countries front-loading inventory, and weak domestic demand, have all played a role. A growing share of that surplus is now with the euro area - a significant shift, particularly for Germany. Add the risk of fresh EU-US tariffs linked to Greenland, and the trade backdrop would normally argue for a weaker euro.

Positioning

Finally, there's positioning. Whether investors express a view in rates or FX often comes down to how crowded the trade already is. According to the CFTC, speculative accounts are now short euro futures - a sharp reversal from the long positions seen in mid-2025. It's harder for the euro to fall near-term if it's already positioned.

Bringing it together

Investors are acutely aware that currency moves can overwhelm returns on overseas assets. The euro's near 12% rise against the dollar last year boosted US investors' returns in euro-area assets, but would have equally eroded returns for European investors holding unhedged US bonds and equities.

As ever in FX, the biggest risk might be acting on first impressions. Markets react quickly, but it's the slower, more deliberate response that determines the big moves and where currencies ultimately settle. While instinct might focus on the euro's recent resilience, relatively higher US bond yields are more consistent with a weaker currency. The more considered view - reinforced by the chart - is that the euro ultimately breaks below its recent range over the medium term.