**The dollar is closing in on parity with the euro—at long last**

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More than two years after a bull market in the U.S. dollar supposedly began, the greenback is finally within striking distance of a long-awaited milestone: Parity with the euro.

That’s right: U.S. travelers to Europe may soon be able to exchange dollars for euros on an almost one-to-one basis, an extraordinary shift from early 2014, when one euro was worth $1.40.

Many Wall Street pundits have predicted parity for the greenback for years, arguing that the dollar would appreciate as the Federal Reserve embarked upon a path of monetary-policy normalization. But those forecasts didn’t look likely to pan out until recently.

On Thursday, the euro bought $1.0411, off 0.6% on the session and down more than 4% so far this year, while the ICE U.S. Dollar index [**DXY, +0.60%**](http://www.marketwatch.com/investing/index/dxy?mod=MW_story_quote) a gauge of the buck’s value against a basket of six rival currencies with the euro [**EURUSD, -0.3920%**](http://www.marketwatch.com/investing/currency/eurusd?mod=MW_story_quote) receiving the heaviest weighting, [touched its highest level since January 2003.](http://www.marketwatch.com/story/dollar-surges-against-yen-other-asian-currencies-after-feds-move-2016-12-14)

Economists surveyed by Reuters in late November saw the euro trading at $1.05 by the end of February. But that forecast doesn’t incorporate the hawkish tilt of the Fed’s most recent batch of economic forecasts, which has caused the dollar to vault higher.

Specifically the changes to the “dot plot”—a graph that illustrates Fed policy makers’ expectations for the pace of coming interest-rate hikes—showed a plurality of Fed policy makers believe the central bank will raise interest rates three times next year, up from just two in September.

Currency strategists at Citigroup and Deutsche Bank, two of the world’s largest currency dealers, both see parity in the not-too-distant future.

And Goldman Sachs Group [**GS, -0.68%**](http://www.marketwatch.com/investing/stock/gs?mod=MW_story_quote)  listed the dollar as [one of its top trades for 2017.](http://www.marketwatch.com/story/this-is-goldmans-top-trade-for-2017-2016-11-18)

This shift in the expected path and pace of rate increases is crucial for the dollar: Typically, higher interest rates cause a currency to strengthen by luring foreign investors with the promise of higher returns.

Here are some of the factors that could influence the dollar-euro exchange rate in the coming year.

**Monetary-policy divergence**

Market strategists call this concept “monetary policy divergence”—the notion that the Fed is swiftly moving to raise key interest rates, while other major central banks maintain relatively looser monetary policies.

A week ago, the euro notched its [worst session since the U.K. voted to leave the European Union back in June](http://www.marketwatch.com/story/dollar-buying-takes-a-breather-as-investors-look-ahead-to-central-bank-meetings-2016-12-08) after the European Central Bank extended its quantitative-easing program through the end of 2017, though it did reduce the size of its monthly purchases to €60 billion ($62.4 billion) from €80 billion.

“Clearly, a lot has changed in the interest-rate environment,” said Marvin Loh, senior global markets strategist at BNY Mellon. “Now, we can talk about monetary-policy divergence again with the Fed going one way and the ECB stable but not necessarily looking to tighten their policies.”

**The rise of European populism**

While the contrasting monetary-policy stances of the ECB and the Fed are perhaps the most significant drivers of this trade, “political uncertainty,” as it’s known in the argot of finance, might run a close second.

The U.K.’s vote to leave the European Union and the Italian government’s failure to successfully sell a slate of proposed constitutional reforms to the public have stoked fears about the gathering influence of euroskeptic populism.

Populist parties appear poised to accumulate more political clout as Germany, France and the Netherlands are holding general elections. Polling would suggest that France’s Marine Le Pen has a shot at becoming the next president of France.

Should she win the vote, Le Pen has promised to hold a referendum on EU membership. While significant gains for populist parties in Germany and the Netherlands would probably weigh on the shared currency, “the French election is the biggest threat [to the euro],” said Naeem Aslam, chief market analyst at ThinkForex.com.

Aslam believes Le Pen will win.

**The Trump effect**

The dollar has rallied sharply since the Nov. 8 U.S. presidential election, when President-elect Donald Trump upset Hillary Clinton. Market strategists have largely attributed the greenback’s rapid appreciation to Trump’s proposed policies, notably corporate tax cuts, a massive infrastructure spending bill and protectionism.

Should they be implemented, investors expect that his policies, particularly the infrastructure spending bill, will stoke growth and lift inflationary pressures.

Rising inflation could force the Fed to raise interest rates with more gusto, while also driving Treasury yields [**TMUBMUSD10Y, +3.14%**](http://www.marketwatch.com/investing/bond/tmubmusd10y?countrycode=bx&mod=MW_story_quote) higher. The dollar has a longstanding positive correlation with Treasury yields.

However, some strategists have warned that the market might be getting ahead of itself. Even if Trump succeeds in pushing his proposals forward, it could take years to filter through to the underlying economy—and that could spark a reversal of the Trump-inspired moves across asset markets, said James Swanson, chief investment strategist and portfolio manager at MFS Investment Management.

“To ramp up government spending to any material degree is a two-to-three year process at best,” Swanson said.

To be sure, if the dollar’s performance over the past two years has taught Wall Street anything, it is don’t count your chickens before they hatch.

“Former Bank of England Governor Mervyn King once said that you have to be mad to forecast foreign exchange rates such is the unpredictability of currencies,” said Steven Barrow, head of G-10 strategy at Standard Bank in a recent Wednesday note.

“We’d go along with that.” Barrow adds.