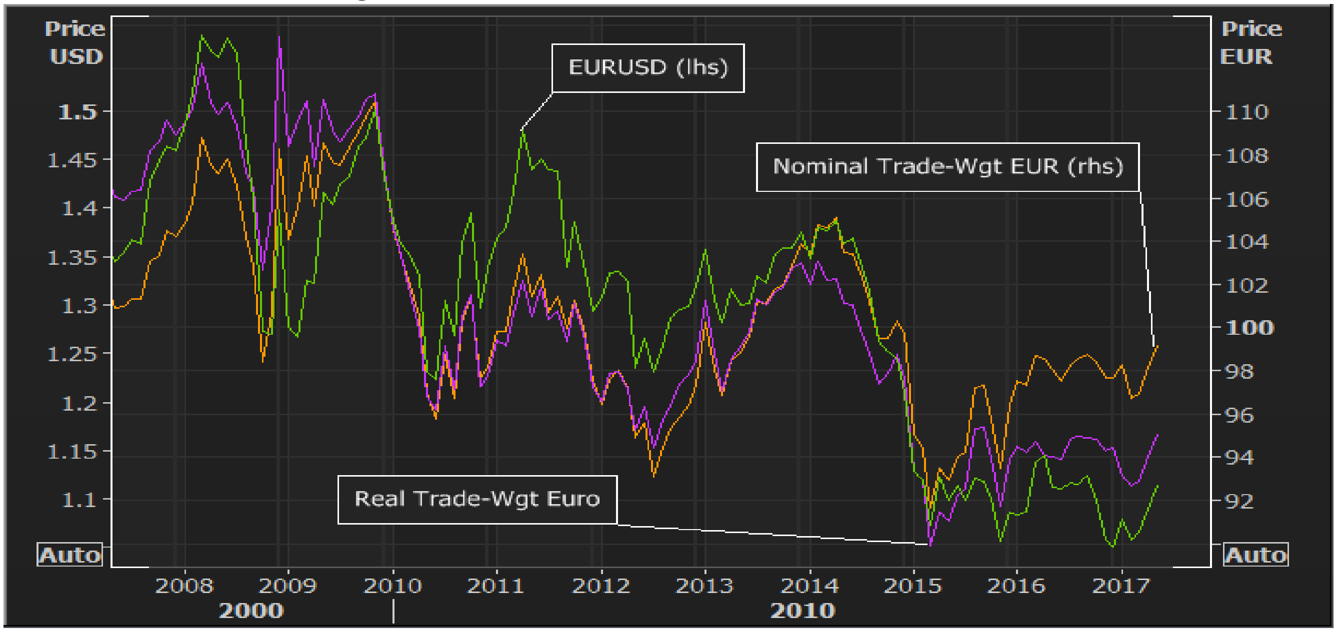
May 2017

Is the Euro Out of the Woods?

EURUSD hit its lowest level (USD1.0039) since 2003 in the run-up to the first round of the French election. The currency recovered ahead of the final round on expectations that Emmanuel Macron would defeat Marine Le Pen – who favored French withdrawal from the Euro - and has rallied further on his victory. The currency was also helped by the less broadcasted but better than expected showing of Chancellor Merkel's CDU party in German regional elections this past weekend which bodes well for national elections scheduled for November. EURUSD is now about12% off the lows and trading at its highest levels since early November of last year despite upcoming French Legislative elections due in June. The prospects for these elections remain very uncertain and it is not clear that Macron will get the backing he will need to implement his ambitious policy agenda. But unlike the Presidential elections, there is little chance that the outcome of the June vote will lead to a move by France to withdraw from the Euro, so should have less impact. Indeed, EUR 2-month implied volatility, which was above 11% ahead of the first round of the Presidential election, is now near a two-year low at around 7.2%.

As shown in the chart below, the post-election bounce in EURUSD, while significant, still leaves it well below the average level of the past decade. The rebound of the nominal trade-weighted EUR has been more significant (reflecting the historically strong USD level) and is getting close to the decade average. But in real terms, the trade-weighted EUR, like EURUSD, remains well below the decade average suggesting there is still significant upside for the currency.

EURUSD and the Trade-Weighted EUR

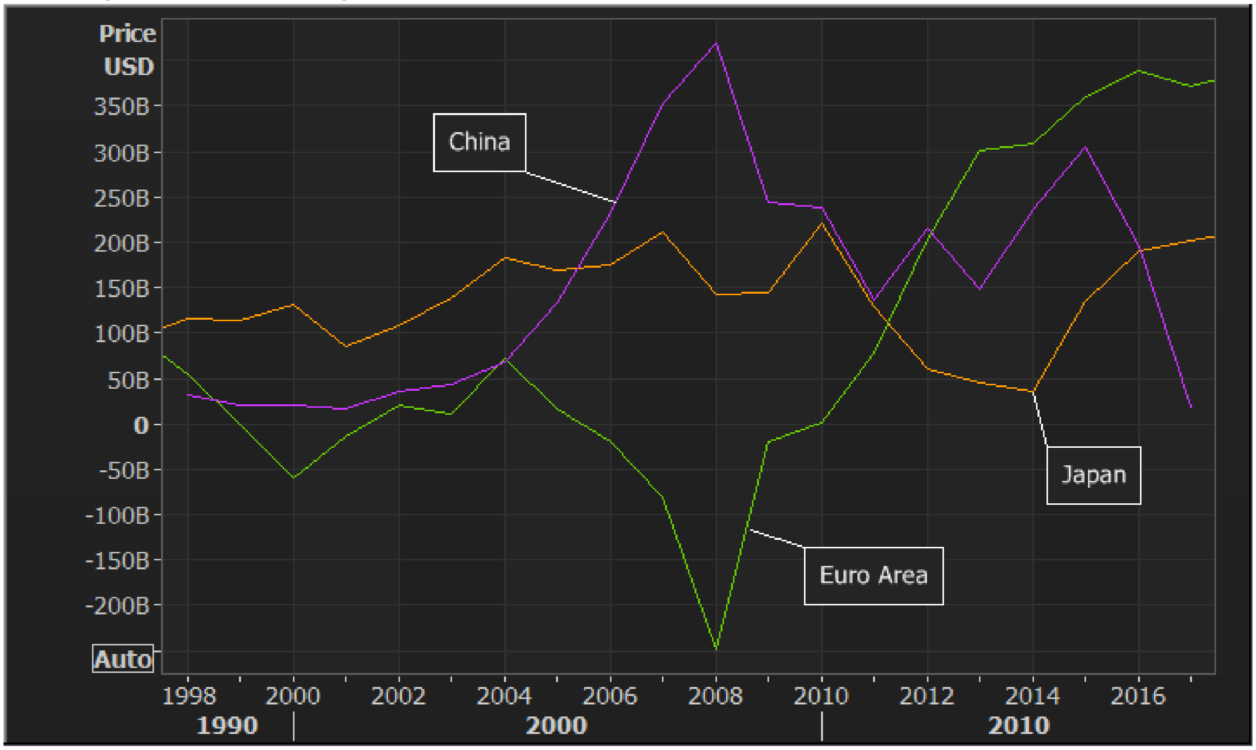


Source: Thomson Reuters Eikon

Real Exchange Rate Paints a Positive Picture for the Euro

The declining real valuation of EUR over the past decade, in theory, provides a competitive boost, an important factor in the Euro-area improved current account balance. As shown below, the surplus is now significantly bigger than Japan's and dwarfs China's. Germany dominates this trend and, in dollar terms, now owns the world's largest current account surplus (though some countries – especially, Japan and Switzerland – have bigger surpluses as a % of GDP). The IMF, just last week, noted this surplus as well as Germany's healthy fiscal position to call for the country to do more to stimulate demand. Low real valuation and the prospects of stronger growth also argue for substantial EUR upside.

Annual (USD Denominated) Current Account Balance



Source: Thomson Reuters Eikon

The Global Economy Also EUR Positive

Copper prices are a traditional indicator of global economic conditions – copper demand is sensitive to global activity – and by inference global risk sentiment. As USD generally trades inversely with sentiment, it follows that EURUSD generally tracks copper prices. As shown below, copper, after making an extended bottom in 2016, bounced back in the fourth quarter and stabilized at a higher price point. This implies an improved level of global activity and is yet another indicator that there is upside in EUR, at least, toward USD1.20.

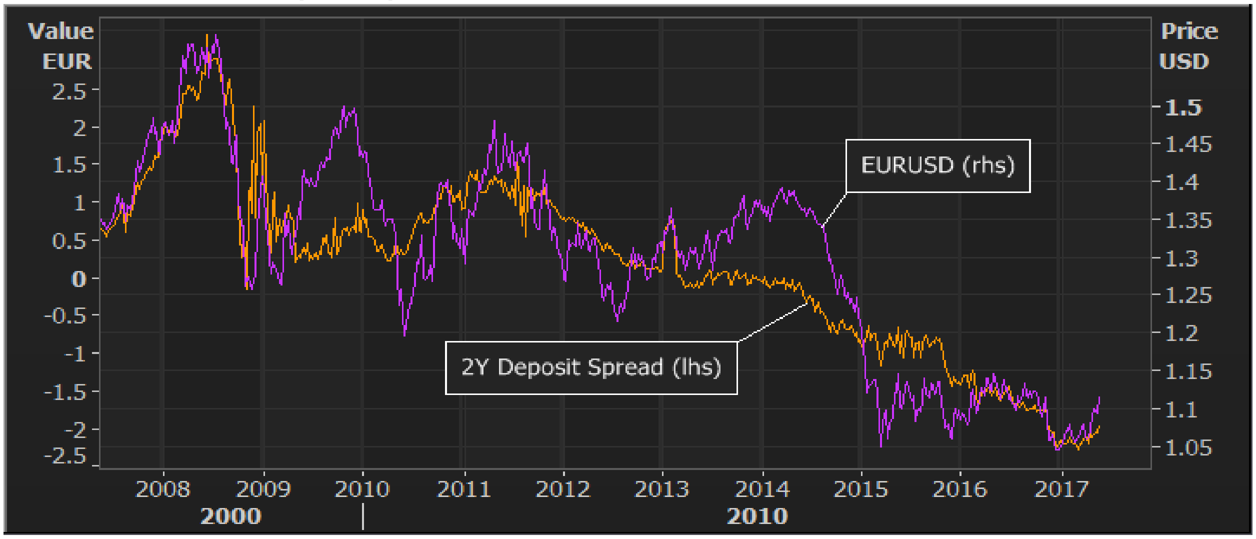
Copper Prices and EURUSD

Source: Thomson Reuters Eikon

Interest Rates Tell a Less Supportive Story

One of the most persistent and reliable drivers of EURUSD has been the spread in the currencies' 2-year deposit rates. The two-year maturity is particularly important as it is a good indicator of relative expectations on long-term central bank policy. The spread has generally been leading the EURUSD downtrend since the financial crisis. The concerns on EUR ahead of the French election led to a low in the spread in conjunction with the bottoming of EURUSD. While the spread has since narrowed (i.e. is less negative), it has lagged the rise in EURUSD suggesting the move is overdone. That said – there have been periods when EURUSD has made temporary but substantial deviations away from the rate-spread trend. An extension of the rally to USD1.20 clearly cannot be ruled out given the positive indicators noted above.

2-Year EUR vs. USD Deposit Spread and EURUSD

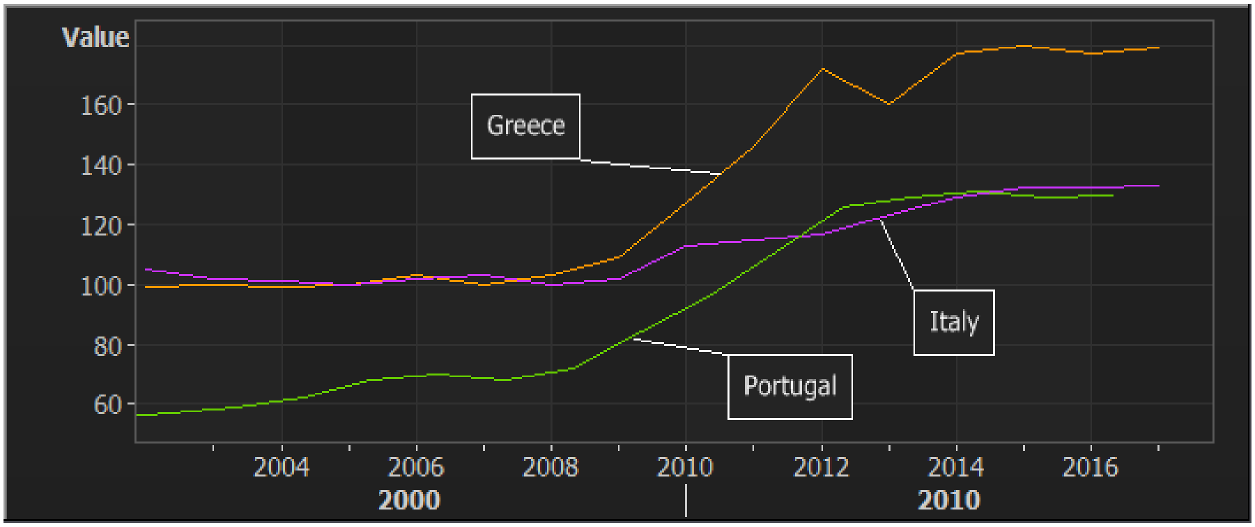


Source: Thomson Reuters Eikon

Debt Picture Remains Fundamentally EUR Bearish

Although the French Presidential election generated concerns about the viability of the Euro, it had relatively little impact on expectations on Greek debt risk. Indeed, the 5-year credit default swap (CDS) on government debt started drifting lower in early March and the election did not significantly affect it. The spread responded positively to the May 1st announcement that Greece had reached an agreement with creditors on a rollover plan for 7 billion EUR in debt maturing this July and now at 654 basis points is at a post-Greek debt crisis low. But, as with past agreements, the debt rollover is based on Greek willingness to further cut the fiscal spending with no discussion of write-downs. As shown in the chart below, this process has produced pain for Greece with no benefit. Despite draconian cuts in spending, Greece's government debt to GDP ratio is actually higher now than when the crisis first emerged. There is no reason to believe the current agreement will be any more successful in reducing the debt burden. And a very ominous trend is that despite very low interest rates and improving European economic conditions, Italy and Portugal's already high debt levels continue to creep up. The ECB's aggressive bond buying activity characterized by Draghi's commitment to "do whatever it takes" coupled with quantitative ease has been instrumental in maintaining stability in Europe's bond markets. But either a sharp slowdown in economic activity or an end to quantitative ease is likely to renew concerns about the potential for default by Greece, as well as, Portugal and Italy which would weigh heavily on EUR.

Government Debt as a Percent of GDP

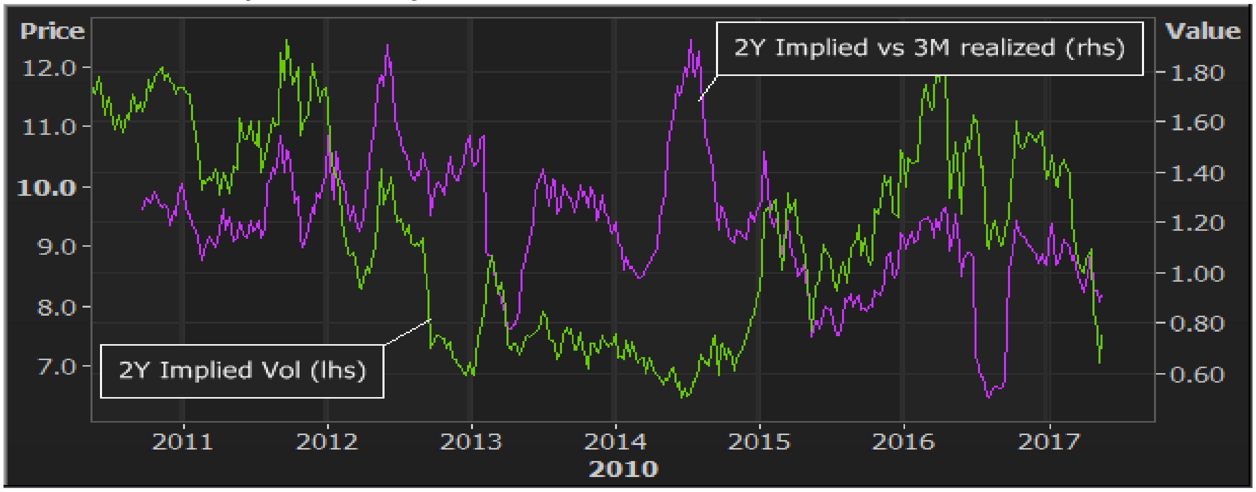


Source: Thomson Reuters Eikon and International Monetary Fund

Does Brexit Matter for EUR?

Apparently not! The UK has begun negotiating its exit from the European Common Market, a process which has a two year deadline. As shown below, EURGBP 2-year implied volatility – which extends beyond the deadline – is at decade lows suggesting the market does not look for the negotiations to have much effect on exchange rates. In part, this reflects the unusually low levels of actual volatility but implied volatility scaled by realized volatility is roughly average so the market does not seem to be pricing Brexit as a major EUR event. EURGBP 2-year risk reversal skew is close to flat which is another indicator of benign expectations.

EURGBP 2-Year Implied Volatility



Source: Thomson Reuters Eikon

So What Does This and the Bumpier Trump Bump Mean for the EUR

EUR upside is dependent on positive global investor sentiment so the equity markets are an important bellwether and normally a downturn in equity markets would be bad news for EUR. But last week's downturn was specifically driven by concerns of the controversies plaguing the Trump Administration. As discussed in the April Market Voice, the post-election rally appeared to be pricing in expectations of market-friendly policies – especially, corporate tax cuts and rollback of bank regulations. There is growing concerns that the turmoil will make it less likely that these policies will be implemented which could make the market more sensitive to political setbacks.

Given that the setback in equity markets was driven by US politics, this may not be a good indicator of near-term prospects for EUR. Copper prices are likely to be a more reliable guide. The French Legislative election (June 11th and 18th) should not be a major EUR-moving event but a strong showing by Macron's La République En Marche! Party would be a plus. But even if conditions remain supportive, EURUSD upside should be limited to around USD1.20 unless there is a material narrowing in the negative rate spreads. Longer run, the prospects for EUR remain negative until an agreement is reached that creates a meaningful reduction in the burden for the EUR-area highly indebted countries.

Market Voice

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