Fixed Income

Parity no more

We are revising our 12-month call for the U.S. dollar to $1.10 per euro

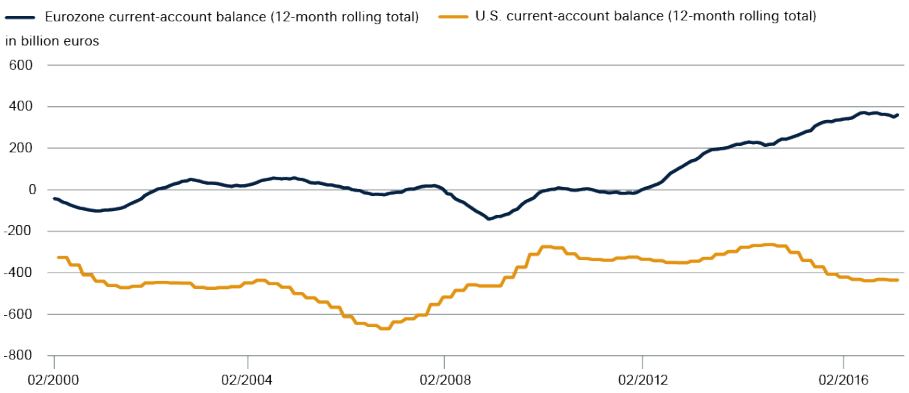
Nothing lasts forever. Since 2014, we have strategically favored a stronger U.S. dollar (USD) compared to the euro. Our last 12-month call from March of this year still was for the dollar to reach parity within that time frame. We are now revising our strategic call to $1.10 per euro. This is slightly below where the USD is currently trading and roughly in the middle of the trading range we have seen since 2015. Effectively, this puts us in a neutral position.

What changed, you might ask, apart from markets moving against us in recent months? Fair point. We would argue, however, that our call is actually more nuanced than it looks. Start with the fundamentals, which should arguably have favored the euro for quite a while.

Solid fundamentals

Over the very long run, currency movements are supposed to correct imbalances in the trade of goods and services. Following its inception in 1999, the Eurozone as a whole has mostly had a balanced current account. Since 2012, however, the common-currency bloc has been running a sizeable external surplus, thanks to rising competitiveness and an increase in domestic savings (not least due to fiscal austerity). Annualized, exports of goods and services from the Eurozone exceed imports by more than €350bn. This might sound like a small number compared to the investment-related turnover in foreign-exchange markets, but at the margin it is a supporting factor for the euro's external value. Especially when you contrast it with the large and persistent current-account deficit of the U.S. economy.

Eurozone and U.S. current-account balances



Source: Bloomberg Finance L.P.; as of 6/21/17

Stefan Kreuzkamp
Chief Investment Officer

Expectations in a nutshell

- Since 2014, we have strategically favored a stronger U.S. dollar compared to the euro.
- Times are changing and a solid case can now be made for a stronger euro.
- Before fully embracing the euro, however, it is worth remembering the common currency remains a very vulnerable project.

There is a case for a stronger euro

From that perspective, the real question is why the euro has not started to rise much earlier. The answer, of course, lies in the seemingly never-ending drama of the Eurozone debt crises. Times are changing, however. Pro-European parties have done well in recent elections. With Emmanuel Macron the French electorate has sent an outspoken pro-European to the Elysée palace. In Germany, Angela Merkel looks well-placed to remain chancellor for another term. This could create the political scope for grand Franco-German compromises that have been the main engine of European integration for much of the postwar period. Such a deal might even include touchy fiscal subjects, be it a common Eurozone budget, a Eurozone finance minister, or even some joint financing.

In terms of the electoral calendar, Italy is the main remaining source of risk to the Eurozone. As things stand, we don't expect the Italians to be called to the polls until early 2018, May at the latest. This is probably too far away for financial markets to care today. Moreover, Beppe Grillo's populist 5 Star movement has scored poorly in regional elections, which helped to alleviate concerns in markets. Brexit is an issue, of course, but much more so for the United Kingdom (UK) than for the European Union as a whole.

To sum up, political risks have receded quite a bit in the Eurozone. Looking across the Atlantic Ocean, by contrast, things look more uncertain today than at any point in living memory.

A credible case can also be made that when it comes to economic growth, the next few rounds in the never-ending race between the U.S. rabbit and the European turtle look more open than usual. Our macro-economic team makes precisely this case in our forthcoming Quarterly CIO View publication. Moreover, the European Central Bank (ECB) President Draghi's term is set to expire in 2019. Eventually, Europe might end up with a more orthodox central bank, perhaps alongside looser fiscal policies. As history has shown repeatedly, the combination of tighter monetary policy, coupled with easier fiscal policy, may lead to a strengthening of the exchange rate.

But risks of market disappointments along the way

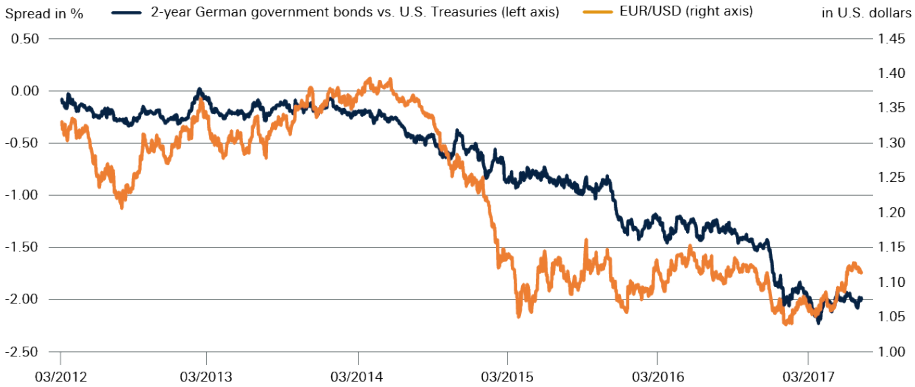
Our main concern is that markets are beginning to expect too much, too quickly from the Eurozone. European integration has always proceeded in fits and starts. Moreover, European policymakers have proven beyond any reasonable doubt in recent years that they are fully capable of failing the economically sensible course of action until it is almost too late. And never, ever underestimate their capacity for political drama along the way.

This is why we are not calling for a stronger euro just yet. All we are saying for now is that net-net, political aspects can no longer be deemed as negative for the EUR/USD exchange rate. Nor can monetary policy – long a decisive factor supporting the dollar over the euro.

The U.S. Federal Reserve (Fed) was quicker than the ECB to deploying "unconventional monetary policy instruments", such as the purchase of debt securities. As a logical consequence, the Fed also started the process of scaling back its unprecedented monetary stimulus earlier: senior policymakers began hinting at an end to its purchasing program in spring 2013. They finally stopped their bond-buying program in 2014, and hiked the key policy rate in late 2015 for the first time in this cycle.

By contrast, the ECB cut rates until March 2016, and even increased its monthly bond purchases. However, there are growing signs that the ECB's governing council starts looking for an exit from its quantitative-easing (QE) program. As things stand, we might get the official announcement at the September meeting. The entry into the exit may well happen in early 2018. We would not expect a sudden stop, but merely gradual phasing out (tapering) over the course of next year, quite similar to the approach used by the American central bank. And after the end of QE, the time might be ripe for the first rate increase by the ECB. Markets are unlikely to wait for the hike. Instead, markets will most probably anticipate the move well in advance. This in turn would end the divergence in interest rates between the euro and the dollar.

Rate differentials



Source: Bloomberg Finance L.P.; as of 6/21/17

Alas, there are good reasons the news flow in coming months may not be as supportive for the euro as it has been in recent weeks. For example, seasonal factors may have depressed first-quarter growth in the U.S. compared to Europe. As far as the U.S. is concerned, plenty of questions remain. Does Trump favor a weaker dollar? And even if he does, might he not still select a "hawkish" successor for Fed chair Janet Yellen, boosting the dollar, however, unintentionally? How much of his health-care and tax-cutting agenda will get passed in the coming months? At this point, any political progress would probably be dollar-positive, given how low market expectations now appear to be.

The bottom line

Before fully embracing the euro, it is worth remembering the common currency remains a very vulnerable project. Until there is clearer evidence of its structural flaws getting addressed, more

signs of comparative economic strength or a more hawkish ECB, we are not ready to revise our call further just yet.

Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Current account

The **current account** includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Five Star Movement

The Five Star Movement is a populist political party in Italy. It is led by the popular comedian and blogger Beppe Grillo, who was also among its founders in 2009. It is considered anti-establishment, environmentalist, anti-globalist and Eurosceptic.

Hawk

Hawks are in favor of a restrictive monetary policy.

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Tapering

Tapering is a slow, continuous reduction of the central bank's asset purchases; especially referring to the U.S. Federal Reserve.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "the **Fed**", is the central bank of the United States.

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