Euro Outlook: Drivers, Direction and Degree

As the third quarter winds down, it is helpful to consider the outlook for the euro-dollar exchange rate in the period ahead. Three dimensions are of particular interest -- drivers, direction, and degree. We place our conclusions first, and then provide the chain of reasoning second.

Conclusion

After rallying about 6.25% since September 10, the euro may enter a consolidative phase before advancing into the $1.38-$1.40 area in the first half of Q4. However, the euro may then surrender those gains in the second half of the quarter, as QEII is discounted (or not delivered at all), and the loss of economic momentum in Europe, ahead of a 2011 fiscal contraction, keeps debt restructuring fears elevated. The increased possibility that the EFSF has to be drawn upon may also spur speculation that the ECB may not be in a position to remove its emergency liquidity provisions; and indeed may have to actually embark on either more bond purchases or take some additional measures. All this may leave the euro trading around $1.30, if not lower, by year's end.

Rationale

Since Bernake's speech at Jackson Hole, the market has acted as if a new bout of long-term asset purchases is increasingly certain. In fact, the FOMC statement saw this action accelerate. The burden of proof has shifted from "significant deterioration" to "no substantial rise in inflation". Moreover, investors know full well that inflation is unlikely to jump before the FOMC meets again. Even the statistical characteristic of US consumer price inflation, which is in part influenced by the data collection itself, makes a sufficiently large rise unlikely.

The impact of all this is felt on the dollar through the interest rate channel. We continue to find that the euro-dollar exchange rate tracks the differential between the US and Germany's 2-year interest rates.

2Y Interest Rate Spread	Date	Euro High/Low	Date
Germany +62 bps	23-Nov-09	Euro High	25-Nov-09
U.S. +31 bps	27-May-10	Euro Low	7-Jun-10
Germany +25 bps	28-Jul-10	Euro High	6-Aug-10
Germany + 7 bps	25-Aug-10	Euro Low	24-Aug-10

The euro's rally in recent weeks coincided with a 30 bps swing of the spread in Germany's favor**:** the spread now stands at its highest since the end of last year. This has been the major force compelling short-covering in the euro and, since the FOMC meeting, some outright long positions being established. This is not to say that such small changes in annualized interest rates is what moves the most liquid currency pair in the world. Rather, the interest rate differential may function as a proxy for various macro-economic forces, including policy initiatives and capital flows.

The next FOMC meeting concludes on November 3, the day after the mid-term election. The risk of QEII may keep the 2-year Treasury yield at historically low levels. It now appears that resolution of the uncertainty over the US tax regime is unlikely to occur before the election. This has significant negative implications for investment plans, as well as for tax withholding, and economic growth.

The second half of the quarter looks more promising. US election outcomes generally circumscribe policy options for the following two years and, if nothing else, may permit resolution of some outstanding issues and uncertainty. The US Commission on fiscal reform is due to unveil their proposals in early December. They will address the obviously unsustainable trajectory of the structural component of the US deficit. While the elections will most likely result in a significant change in the configuration of Congress, the report will likely set the terms of debate. This alone will blunt criticism that the US is in denial about the limitations of fiscal policy.

Europe

The improving news stream in the US is likely to contrast with poorer news from Europe. The US entered its “soft patch” in Q2 and the UK appears to have entered its own in Q3. The euro zone’s turn is coming. After posting strong growth in Q2, some moderation was expected, but the pace of the slowdown may catch many off guard.

Ironically, while it is uncertainty in the US that is economically and politically problematic, certainty is the challenge in Europe. Households and businesses in Europe, for the most part can be certain that taxes will rise and government spending will be cut in 2011. Their behavior will follow accordingly, and this will likely weigh on economic activity.

The European financial markets may come under more stress as the quarter progresses. While some investment banks are recommending buying peripheral bonds in Europe, the record premium that Portugal and Ireland are being forced to pay, and/or the price of default insurance in the credit-default swap market, continues to rise. This reflects the assessment of many that present debt dynamics cannot be sustained.

The EFSF is the first line of defense, but its existence simply allows a stricken country to take on more debt; compounding, rather than resolving, that country’s indebtedness. Moreover, as we have previously argued, when one really looks at the details it is clear that the lending power of the EFSF is considerably less than guaranteed €440 bln figure so widely touted

Ideally Greece, Portugal, and Ireland would implement a “friendly” or “voluntary” debt restructuring. Their debt dynamics, and the fact that they do not control monetary policy levers, limits their options. Pride and prestige, not only on the national level but also at the EC and ECB levels, appear to be the chief obstacles to such a reasonable resolution. If these issues are not resolved, they will continue to smolder.

Technical Considerations

It is not that medium-term investors, such as asset managers, need to follow technical analysis. However, an important part of the valuation process lies in understanding prices not only in terms of macro-economic factors but also in the context of recent price performance.

With the euro's advance after the most recent FOMC meeting, all of the major currencies are now trading above their 200-day moving averages. The relationship between the 50- and 200-day moving averages earlier this year helped boost our bullish dollar view. In February, the shorter-term moving average crossed below the longer, for sterling first, then the euro, followed, and finally for the Swiss franc's average turned at the end of the month. Half year later we find these moving averages are now reversing. The Swiss franc's average crossed early in the second half of August, followed by sterling in early September. While the euro's averages have not yet crossed, conservative assumptions, place this possible in early Q4.

From a somewhat more technical point of view, it appears that the euro's upside correction to the Nov 09-May 10 22% decline is not complete. Meanwhile, the downtrend line can be drawn off the 2008 and 2009 euro highs that come in around $1.45 by early November. And given the expected shift in the news stream, it appears a bit extreme. On the other hand the 50% of the Nov 09-May 10 move comes in $1.35 may be too close given the expected news stream and market positioning. The next common retracement objective is near $1.39.