Seven constructive remarks about the euro

It has been all about euro weakness of late, with the market selling heavily and sometimes overreacting to any kind of bearish development (see last Friday's exaggerated price action following a diplomatic gaffe by Hungary's politicians). On the other hand, the euro is failing to rally on good news – whether of an economic or a political nature. In this context, it is rather controversial to be anything but a euro bear, but this may be the time to identify a few constructive developments and to get prepared for a potential correction.

i) A weaker euro is good news for the euro zone economy

The euro has lost nearly 20% versus the US dollar, 21% against the yen and over 7% versus sterling since the beginning of the year, representing a substantial easing in monetary conditions. This is a highly welcome development at this very early stage of the recovery and given the much tighter fiscal stance resulting from the debt crisis. The benefits of a weaker euro are already feeding through the data, in Germany in particular. This is well captured by surging net exports (the cumulative German trade surplus to April 2010 stands at Eur51bn which compares to a Eur37bn at the same time last year), with strong positive spill-over effects on industrial orders and industrial production. At a micro level, EADS latest signing on a large Middle East order can also, to some extent, be associated to the weaker euro. In turn, all this will feed through into the domestic economy and if the German and French economies do well, it is very good news for the rest of the euro zone.

ii) Debt Crisis has been an incentive to address long-term structural problems in the euro zone

Euro zone structural problems are hardly news and we would argue that if it was not for the crisis, those issues would never have been addressed – as they are politically highly unpopular and usually associated to social unrest. In aftermath of the Greek, we would argue that countries such as Spain, Italy or Portugal undertook a series of fiscal tightening measures that would otherwise probably not have been considered. Even Germany announced an Eur80bn austerity measure package earlier this week which will improve the fiscal position further (with Chancellor Merkel aiming at bringing the budget deficit to GDP ratio down from the current 5%, with a structural deficit target at just 0.35% of GDP by 2016). Note that out of all euro zone countries, we believe that Germany did not need to introduce fresh austerity measures at this point in the cycle. This is another story/debate though.

iii) Euro zone a step ahead vs the US when it comes to addressing debt problems

While the euro zone is being pushed into fiscal consolidation and into addressing the huge debt burdens, the US is doing little in this domain. This is clearly not a dollar concern at this point, but it could prove more of a bearish force for the greenback later in the cycle. US policy makers believe that maintaining loose fiscal policies will promote GDP growth and generate revenues that will help curb deficits in the future. This may prove right, but in the meantime, the US debt has risen to a high $13tn, rising by $1.6tn last year and doubling over the past decade. The US debt to GDP ratio currently stands at 90% (in 2009, the euro zone debt as a percentage of GDP stood at 78.7%). We wrote a recent report showing that assuming no action is taken the US structural deficit could be at 6% of GDP in 2015, which compares to 4% for the euro zone. Add to this the fact that US mandatory spending and debt servicing could reach up to 18% of GDP and it becomes clear that the whole US debt issue must be addressed sooner rather than later.

iv) the Franco-German axis is back on track

Part of the May sell-off resulted from increased market jitters that the Franco-German axis, the core of the euro zone and of the European construction through the years was at risk. This resulted from reports that French President Sarkozy (later denied of course) had threatened to leave the euro during the European Stabilisation Mechanism discussions and following Germany's decision to unilaterally ban naked short selling. Developments of the past couple of days (in particular this morning's joint letter from France and Germany) have conveyed a much more united position from France and Germany which have voiced, together, a need for tighter financial regulation. This is important as a good Franco-German relation is crucial for the euro.

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v) The euro bear trade may be overcrowded

The euro has become a one way downward trade and our sell in the rallies strategy has worked well over the past few weeks. However, this is not just a BBH view and it kind of feels like this is an overcrowded trade. In the option market, the 3 month risk reversal indicator has reached a record low of -3.37 on Monday (implying extreme bearishness) but has recovered since (trading at -3.04 today), pointing at some respite for the euro. 3 month volatility (which correlates negatively with the euro spot rate) has come down from the high 16.25 reached on Monday (currently trading at 15.63) and this may also be an early sign of a possible correction. Moreover, the latest CFTC figures show that net short euro positions remain extremely large but have recovered from the -106736 level seen on the May 25th week (currently at -93325), also possibly indicative of a potential bounce to come in the euro.

vi) At $1.20, the euro is fairly valued, no panic

The euro has clearly come down fast over the past few weeks: by 10% versus the US dollar and nearly 14% against the yen since the beginning of May, but the move has been better controlled since the beginning of the year (-20% vs the US dollar and 22% vs the yen). In comparison, over the May-November 09 period, the US dollar was down 12% versus the euro. It is just the May moves that should be source for concern from a euro perspective. However, the euro is now trading close to fair value and close to its birth rate. It could be much worse given the type of demolishing/end of the euro arguments that have been brought forward by some market participants in the Greek crisis context. Only a couple of days ago did the highly respected UK Telegraph referred to a survey suggesting that the euro will be finished within the next five years. Considering this kind of mood, why is the euro not trading much lower than the current fair value - note that the historical record low was the October 2000 low of 0.8230. 46% lower from the current level. Considering that we are going through the most severe crisis in the euro zone history, the euro is doing rather well at $1.20.

vii) Central Banks are not moving away from the euro at this point

A news wire reported earlier today that Russia remains committed to diversifying its reserves and has not changed its view of the euro. This is consistent with what several other central banks, including China, Japan and South Korea have indicated recently.

We are not abandoning our bearish medium-term euro outlook but at a time when the market has become highly biased to euro weakness, it is important to acknowledge some supportive aspects and to highlight the risk of a near-term correction. The euro has pushed back above $1.20 in early US session, with further resistance identified at $1.2040 and then $1.2150.

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