

## Euro-Dollar Outlook

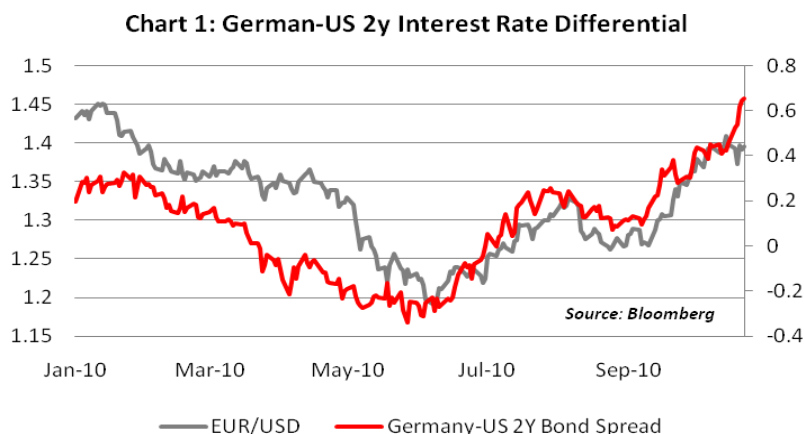
**Executive Summary:** *We suspect the dollar's decline against the euro is reaching its final stages. US interest rates appear to have largely priced in some form of quantitative easing by the Federal Reserve (though headline risk remains in terms of the actual decision) and European rates have risen to a price in the risk of an ECB rate hike in Q1 11. Medium-term investors may want to consider reducing short dollar exposures. However, prudence suggests waiting for interest rate differentials to turn before taking on new long dollar exposure.*

### The ECB Trumps the Fed

The main accelerant fueling the dollar's descent has been the anticipation of new long-term asset purchases by the Federal Reserve. Although investors are fairly certain that the Fed will announce this at the end of the next FOMC meeting (the day after the November 2 elections) there is much less certainty about the details. Nevertheless, given the decline in US yields -- the market appears to have gone a long way toward discounting some action.

In fact, US rates have stopped declining. The US 10-year yield bottomed on October 7 and has risen about 15 bp since then. The US 2-year yield bottomed on October 8 at just below 35 bp and has been bouncing along that trough for the past couple of weeks.

Yet interest rate differentials with Europe continue to move against the dollar (Chart 1). The premium that the US offered over Germany has all but disappeared at the long-end. The 10-year differential was a mere 13 bps when the US yield stopped falling. On October 20 it was less than 4 bps. US 2-year yields, for example, are presently around 65 bps below similar German yields -- a 20 bp move in Germany's favor over the past two weeks. Both of these are 11-month extreme readings.



There has been a shift in the driver of the spread. Initially, it was QEII, but now it is the words and deeds of the European Central Bank, which seems determined to normalize monetary policy. It has proceeded methodically to end its long-term repo operations, and the end of the unlimited nature of the short-term refi operations is anticipated. For the first time in more than a year, 3-month Euribor has returned to the ECB's refi rate of 1.0%. ECB Council member Juergen Stark has suggested that the ECB might raise rates before it fully exits some of the measures taken during the crisis. The derivative and swaps market suggests the market has discounted to a large extent a 25 bp hike in Q1 11.

This seems unwarranted for an economy that the ECB expects to expand by only 1.2% next year, which would follow the meager 1% expansion projected for this year. In addition, it expects CPI to increase 1.6% next year. And in September headline consumer prices in the euro zone were 1.8% higher from a year earlier, while the core rate was 1%.

### Headwinds in Europe Coming

Market participants still remember the ECB's rate hike in early July 2008, which came just as the financial crisis had begun intensifying and the euro was approaching \$1.60. Furthermore, expectations of the likely trajectory of ECB policy are underscored by the impression many investors have formed that Axel Weber, the Bundesbank head and among the most hawkish members of the ECB, is most likely to replace Jean-Claude Trichet in a year's time.

The dollar's precipitous fall, then, is a reflection of the divergence between US and European policy. The uncertainty over QEII will be lifted in a couple of weeks and, within days of the mid-term election, the US is likely to report its first increase in non-farm payrolls since May.

The combination of higher interest rates, anticipation of tighter fiscal policy and the stronger currency (nearly 7% rise on a trade-weighted basis over the past seven weeks) should be expected to accelerate the euro zone's slow down after peaking in Q2. The German economy remains the engine of the euro-zone and the recent string of survey data (ZEW, PMI, ISM) has surprised on the upside. Domestic demand, however, remains soft with retail sales contracting in August and exports falling two consecutive months (July and August) for the first time this year.

Some European officials have already expressed concern about the pace of the euro's appreciation and no doubt US Treasury Secretary Geithner's comment that the major currencies are roughly in alignment was welcome (and allows a united front when addressing currency issues within the G20).

### Clues

In addition to monitoring the interest rate differential between the US and Germany there are other important indicators that investors, even those not technically inclined, should consider monitoring.

One trend following tool we find helpful is the 5 and 20 day moving averages system (Chart 2). As the chart here shows, it has done well in capturing the big moves over the past six months. It identified the euro's downtrend from mid-April through mid-June and its recovery through mid-August. It caught the down move into early September. It then got a bit whipsawed before the bullish turn in mid-September. The bullish signal was generated when the euro was near \$1.30. The moving averages appear poised to cross again in the coming days, generating a bearish signal.

Another tool to consider is the relationship between the pricing of (three-month 25 delta) euro calls and euro puts. Even if one does not use options, the derivatives market may identify the turn in the spot market. The key concept here is that theoretically calls and puts should be equally distant from the forward price, thereby having the same value. To the extent they are not, of course, reveals a bias.

Last October and November, our confidence in a dollar recovery was boosted by our observation that although the euro remained firm, the market had shown a clear and increasing bias toward euro puts, reversing the earlier bias that began in March 09 that favored euro calls. Our understanding was that this was largely a reflection of insurance against long euro exposure. Namely, we saw it as a sign that the market's confidence in the euro was waning.

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The bias favoring euro puts continued through mid-June, when the skew was nearly 3.5%. Since then the skew favoring euro puts has steadily diminished, slipping to a little less than 0.6% on October 18, (although choppy trading in recent days has seen the premium back up slightly, to about 0.9%.) If the premium for euro puts continues to increase, it would add to our confidence that the dollar's decline is in its terminal stage.

Chart 2: EUR/USD Spot &amp; Moving Averages

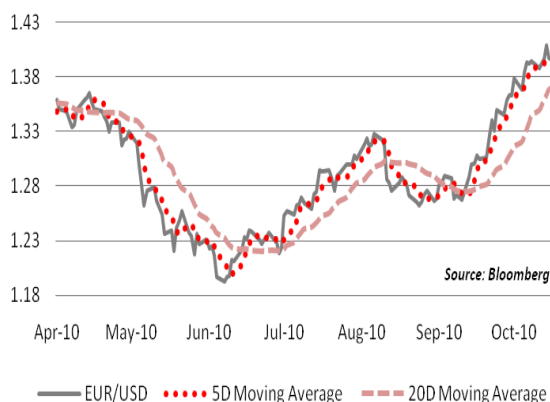
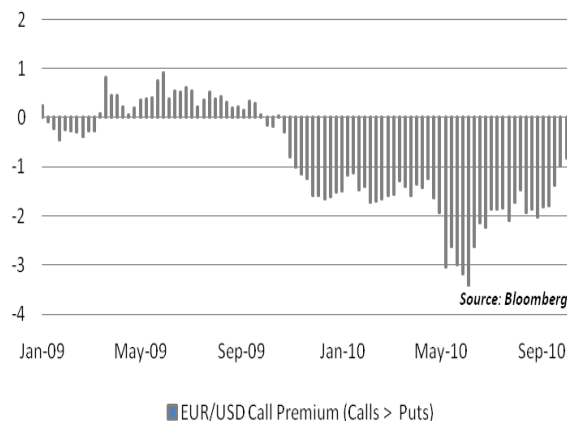


Chart 3: EUR/USD Call Premium (Calls &gt; Puts)



## Outlook

Since the Fed signaled the likelihood of QEII, we had anticipated the euro climbing to \$1.40. With interest rate differentials still moving against the US, we are reluctant to call a significant dollar rally, but we suspect one is beginning to be carved out.

Various indicators, including sentiment and positioning, warn that the long euro position is a crowded trade. Given our expectation that the macro-economic divergence between the US and the euro-zone is likely to close over the next couple of months, we are hesitant to advise medium-term investors to chase the euro higher. Meanwhile, there is some risk that the euro advance extends toward \$1.43-\$1.45 -- that last part of the move may be better captured by nimble short-term momentum players, not investors.

Admittedly, it got whipsawed a bit before the bullish turn in mid-September but the bullish signal was generated when the euro was near \$1.30. It appears that the moving averages are likely to cross, generating a bearish signal in the coming days. The euro's resilience makes its signal a laggard. Sterling's moving averages crossed on Oct 21 and Swiss franc's average will likely cross on Oct 25. Not that this is an infallible guide, but investors, even those not technically inclined, may want to monitor these price developments.

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