MARKET VOICE

July 2018

The Ebb and Flow in Global Markets

The March Market Voice focused on three factors which explained the seemingly perverse EUR strength in the face of an increasing USD interest rate advantage:

1) The EUR was historically cheap in real terms when it bottomed.
2) Central bank – especially China – diversification away from the dollar may have been a source of strength.
3) The relative value of equity markets may have been compelling enough to overwhelm the negative rate picture.

We felt these three factors were generating substantial enough flows into EUR that defeated the negative interest rate environment. But in March when the article was published, it appeared these factors were fully priced in, so we expected the traditional relationship between interest rate spreads and the EUR to re-emerge. As shown below, the USD 2-year rate advantage has widened about 30 basis points in response to the most recent Fed rate hike. The EUR indeed responded in traditional fashion declining from around USD1.230 at the time of the March article to its current value of around USD1.176 – or about 4.6% lower.

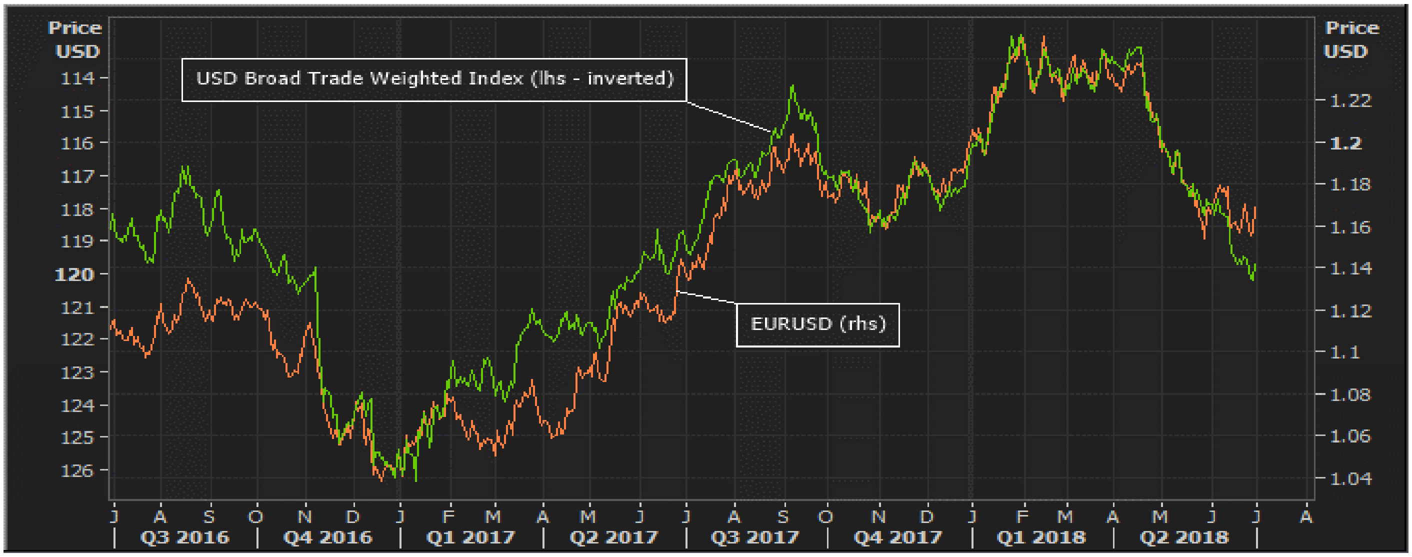
Figure 1: EURUSD and 2Y U.S. vs Germany Government Bond Spread

Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

The movement of the EUR vs the USD appears to have been strongly linked to broader USD trends. Figure 2 shows that most of the seemingly abnormal EUR movements over the past year paralleled the broad trade weighted dollar trends (The JPM broad nominal dollar index). In other words, EURUSD strength in the first quarter of 2018 was by and large USD weakness rather than EUR strength. That was nonetheless a paradox as described in the March Market Voice, in the face of a growing interest rate advantage for the dollar against all developed country currencies and many emerging currencies.

It was only in the past month or so that the EUR showed any significant deviation from general USD performance.

Figure 2: EURUSD and the Trade-Weighted USD Nominal Index



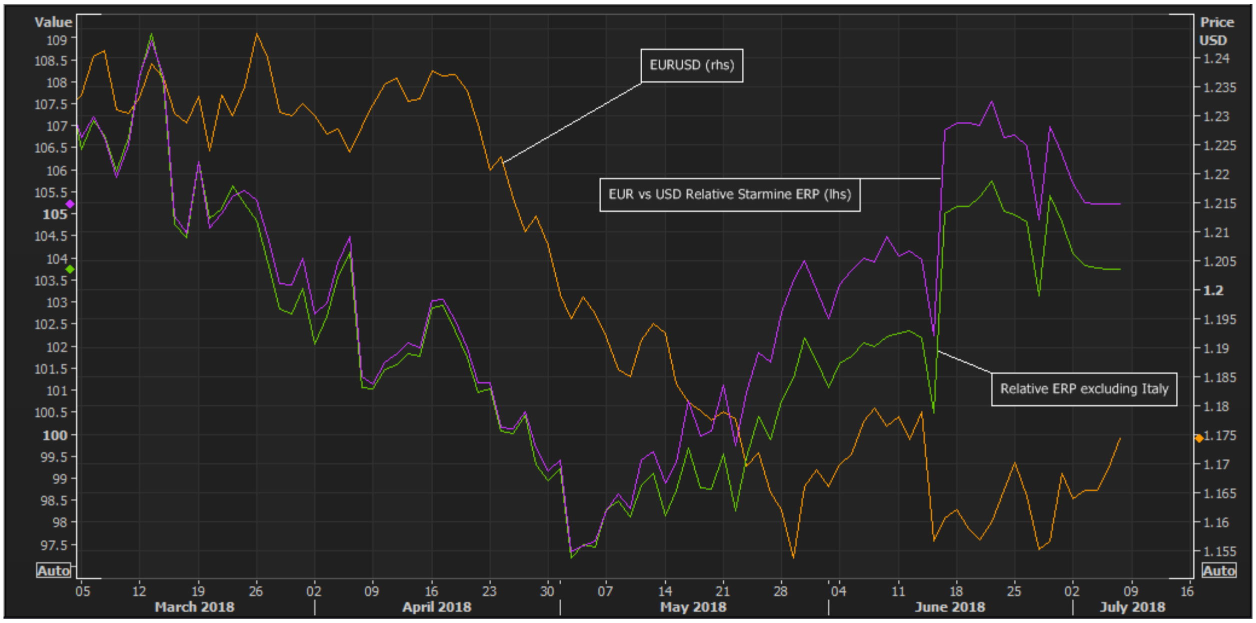
Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

Meanwhile EURUSD still shows some enigmatic behavior; despite the recent declines it has stabilized around USD1.17 even as the broad dollar continued to strengthen.

Surfing on Relative Equity Valuation

A seemingly important factor that abetted the Euro's decline was the shift in relative attractiveness between the U.S. and European equity markets. In the March Market Voice, it was noted that the EUR's lofty levels, in part, reflected the higher StarMine estimated risk premium for the European stock markets (weighted average of the individual national markets) relative to the U.S. market (i.e., European stocks were cheap). The fact that the EUR seemed to have fully priced the return differential in mid-March was another factor we saw biasing the EUR for weakness. As shown in the chart below, the decline of the EUR was led by a reduction in the European relative risk premium.

Figure 3: EURUSD and StarMine Relative Risk Measure for the European vs U.S. Equity Markets



Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

The recovery of most of the lost ground in the relative premium since early May is more puzzling, but should be seen in light of the following facts:

- It might have helped the EUR stabilize (instead of falling further in line with other non-USD currencies), as highlighted in the comparison with the broad dollar index in the previous paragraph;
- The tension in European risk premium in the past two months appears to have been largely driven by concerns over political risk in Italy. In figure 3, we can see a clear divergence in that metric excluding Italy since early May.

The sudden correction in stock prices as the result of the Italian situation mechanically inflated the risk premia. But that situation is unlikely to persist in the medium term, as we would expect equity valuations to normalize, or earnings and growth forecasts to be revised down, should the pessimistic outlook materialize.

In any case, such context of renewed political risk was not supportive of large-scale flows in favor of the EUR.

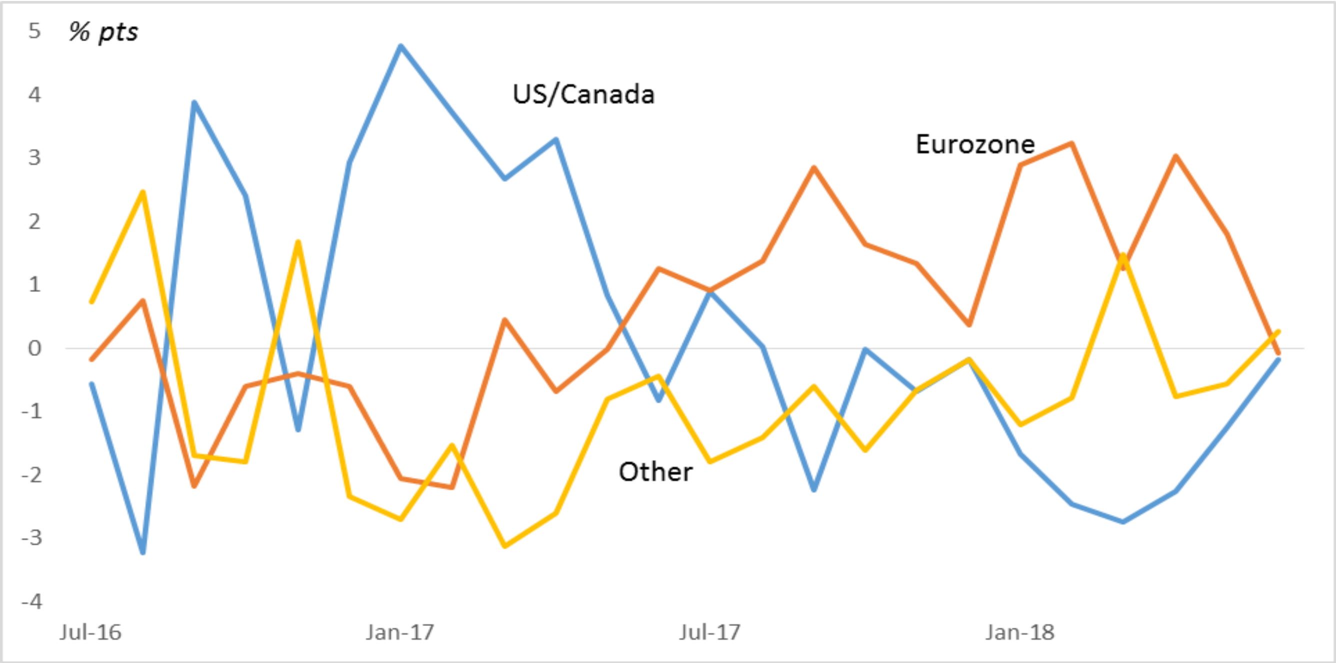
A Global Competition for National Equity Markets

In addition to relative valuation levels, a look at the Eikon Asset Allocation Poll app supports our idea that investor cross-border equity flows may have overwhelmed the impact of rising rate spreads. As shown in figure 4, global allocations into the U.S. equity market surged in the first half of 2017 which could have been the source of the dollar's strength at that time. The flows flipped in the middle of last year; there was a steady year-over-year decline of the percent of global equity portfolios allocated to the North American Equity markets. Notably, markets in the Eurozone were the chief beneficiary of the outflows from the U.S. Market. The equity reallocations are consistent with the dollar's delink from rate spreads late last year but switching back to strength in recent months. Europe being the chief beneficiary of outflows from U.S. equities would be a rationale for why the EUR would be outperforming other currencies vs the dollar.

The EUR equity market seems to have won the global competition for investor dollars in the first half of the year. But things look less rosy for the EUR as we enter the second half. There are growing political tension in Europe; in particular, the new Italian government is resistant to cutting spending to be in line with the Maastricht agreed levels for fiscal deficits creating renewed concerns on the viability of the EUR. Shifts in other European governments – including Merkel's diminishing control in Germany – are also sources of concern as is the pending move by the UK to exit the European Common Market (Brexit).

As is apparent in the asset allocation flow chart, the inflows into European equities recently dried up. If this trend turns negative over the summer, the EUR is likely to lose support and decline to align with the gains of the broad dollar. We think another factor potentially inciting EUR weakness will be that fiscal uncertainty will force the ECB to continue supporting national bond markets – especially Italy – making it difficult for them to withdraw from their policy of quantitative easing as they have indicated is their intent.

Figure 4: Year-over-Year Change in Global Allocation of Equity Holdings



Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

The Bottom Line

As was highlighted in the March article, equity flows appear to have been a key driver of movements in the major EURUSD currency pair. In addition to the StarMine implied relative pricing advantage of European equities, despite a rising rate advantage, the Asset Allocation Poll shows the dollar broadly suffered from a global equity allocation away from U.S. markets late last year into the early months of this year. But the outflows from the U.S. receded in the second quarter. Moreover, negative political developments in Europe now seem to be deterring foreign equity inflows. If this trend continues into the summer, the EUR is vulnerable to additional weakness as it catches up with the dollar's general rebound.

About the Author

Pierre Vidal manages the Thomson Reuters product proposition for FX markets globally, driving the strategy to serve both sell-side and buy-side market participants. Pierre worked in a financial software start-up prior to joining Thomson Reuters. He then pursued a 20-year career in product management roles focusing on financial modeling and analysis, with specific expertise in OTC derivatives.

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