portfolio construction forum

Beware the euro consensus

Anatole Kaletsky | GaveKal | 16 March 2015

The US dollar is hitting new 12-year highs almost daily and the euro seems to be plunging inexorably to below parity. Recent events in the foreign exchange markets seem to have a fairly obvious explanation which most economists and policymakers accept and endorse. President Hollande, for one, has embraced the plunging euro: "It makes things nice and clear: one euro equals a dollar," he told an audience of industrialists last week. But it is exactly when things seem "nice and clear" that investors must question conventional wisdom - strong dollar/weak euro has certainly been the most popular trade of 2015. So, is there a chance that this trend may already be overshooting?

In one sense, the conventional explanation of the recent euro-dollar move is surely right. The main driving force has clearly been the divergence of monetary policies across the Atlantic. But how much of this divergence is already priced in? This depends on how many people either do not know about the divergence of interest rates or do not believe it will go very far. Last year, many investors questioned the European Central Bank's ability to launch a bond-buying program against German opposition and many others doubted the Fed's ability to tighten money, since this could abort the US economic recovery. That's why a year ago, the euro was still worth almost US$1.40 and why all of us at Gavekal expected the euro/US dollar to fall a long way. But the scope for dollar-bullish or euro-bearish surprises is very different today. Does anyone still believe that the US economy is on the brink of recession? Or that the Bundesbank has the power to overrule Mario Draghi on whatever he wants to do?

Since so much of the monetary divergence is now discounted, perhaps we should focus more attention on the other factors that could influence currency movements in the months ahead. In favor of a stronger dollar and weaker euro, there seem to be three potential drivers.

1. The Fed could raise interest rates substantially faster than already expected;
2. Investors and corporate treasurers could become increasingly confident and aggressive in borrowing euros to convert into dollars and take advantage of higher US rates; and,
3. Asian and Middle Eastern central banks or sovereign wealth funds could take advantage of the ECB's bond purchase program to sell increasing proportions of their German, French or Italian bonds and reinvest the proceeds in higher yielding US treasuries.

These are all powerful forces, but they could be counterbalanced by at least four factors pressuring dollar/euro the other way.

1. There is the effect of the strong dollar itself on the US economy and monetary policy. If the dollar keeps rising, US activity and inflation will weaken. Thus the Fed, instead of raising interest rates faster than expected, will, in this event, probably become more dovish.
2. There must be serious doubts about whether Asian and Middle Eastern governments will want to shift reserves into dollars, especially if this means converting the euros they have acquired since 2003 at a loss and far below their purchasing power parity. Many countries have spent decades diversifying their wealth away from dollars, for reasons that are both financial and geopolitical. With the US increasingly prone to use its currency as an instrument of diplomacy and even of warfare - a process known in Washington as "weaponising the dollar" - China, Russia or Saudi Arabia may well be reluctant to switch even more of their wealth into US treasury bonds.
3. The trade imbalance between the US and Europe. This is already big, with the US forecast by the International Monetary Fund to run a current account deficit in 2015 of US$484bn and the eurozone a surplus of US$262bn; these are almost certain to widen further because of the euro's 20% devaluation since the forecasts which were made in the autumn. The implication is that almost US$1trn of capital will have to flow annually to the US from Europe just to maintain the present euro/dollar exchange rate. And as the trans-Atlantic trade imbalance widens further, ever bigger capital flows will be needed to keep pushing the euro down. Such huge capital flows are perfectly possible, but the question is what will drive them, which leads to the most important reason for expecting the euro's decline to reverse, or at least stabilise.
4. While the US will attract some investors with higher interest rates, other investors will move in the opposite direction if a genuine economic recovery in Europe is generated by the combination of a more competitive euro, the ECB's enormous monetary stimulus and an easing of fiscal pressures in France, Italy and Spain. The resulting flows of global capital into European shares, property and direct business investments that are now substantially cheaper than corresponding US assets could easily outweigh the cash and bond investments attracted by rising US interest rates. Concerns about European equities being expensive are only relevant when the effect of the cycle is ignored on the assumption that Europe remains in its slump indefinitely. If eurozone unemployment halves in the next few years (i.e. a similar performance to the US and Britain after quantitative easing and fiscal easing), then current European valuations will look like a bargain. It is worth remembering that cyclical stocks should usually be bought when their earnings multiples are high and sold when those multiples are low.

© PortfolioConstruction Forum 2015

What, then, will be the balance between these opposing currency forces? Nobody can say for sure, but one thing is certain. Whereas the profits from playing trans-Atlantic interest differentials may run to 1% to 2% a year, investors can easily lose that amount in a single day or even an hour, by buying the wrong currency when the trend turns. As we know from decades of Japanese and Swiss experience, selling a low-interest currency simply because of higher US yields is often a very costly mistake.

Anatole Kaletsky is co-founder and GaveKal Research, GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.