RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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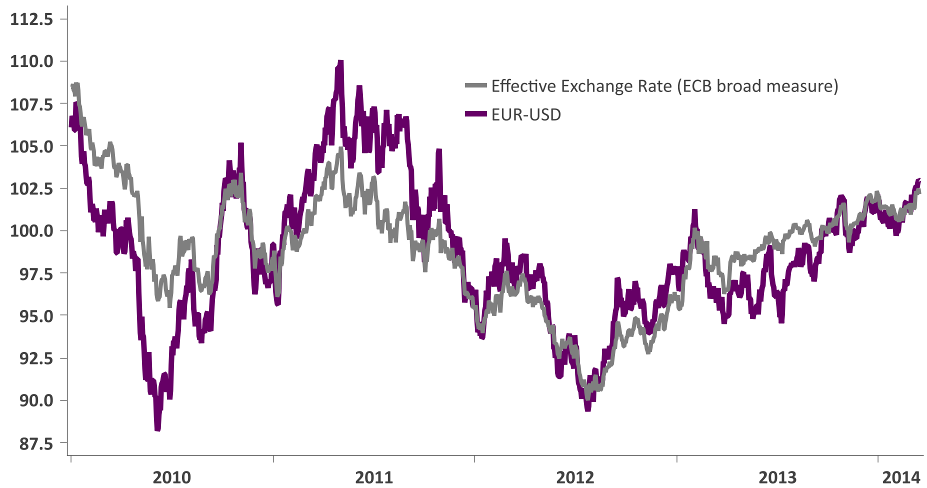
GLOBAL MACRO

The appreciating euro or the competitive deflation trap

You heard it here first: the euro would not drop versus the dollar and could even increase. And here we are. During trading yesterday, the euro flirted with USD 1.40, its highest level since October 2011 after gaining in excess of 7% since the start of the year. This is a worrying development, which could erase nearly all of the support that improving global conditions have provided to exports.

Euro Exchange Rate

Jan. 2010=100



Sources: RichesFlores Research, Macrobond

Two reasons explain why our forecasts, unlike the market consensus, never strayed from the EUR 1.40/euro exchange rate in the past two years:

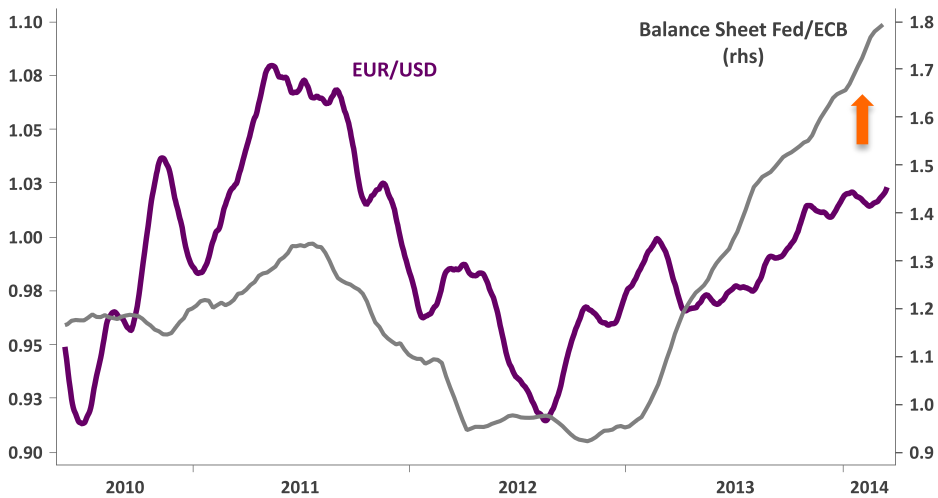
• the first is rooted in our skepticism with regard to 1) the consensus that the US economy is presumably in good health and 2) anticipations that the Fed would normalize its monetary policy in response to the expected improvement.

• the second is grounded in the side effects of the competitive deflation policies carried out by the EMU countries. The shrinking inflation gap between the euro area and the rest of the world, resulting from these policies, protects the currency's purchasing power. Consequently, these policies offer de facto support to the euro, particularly versus the greenback whose value is automatically diluted by the massive scale of pump priming in recent years.

Therefore, it is hardly surprising that the recent disappointments on American growth have pushed the euro higher, especially since the ECB dashed all hopes of additional monetary easing last week. The trend is alarming for at least three different reasons.

1- First, because the euro could actually continue to appreciate.
We did not forecast the exchange rate to pass the USD 1.40 threshold before late 2014, consistent with our expectations of slowing US growth in the second half. However, this slowdown may already be underway if data from this early part of the year is any indication. This observation is certainly not a good sign for the dollar - regardless of whether the Fed puts the brakes on its tapering in the coming months.
In fact, even though asset purchases have slowed since the start of the year, the Fed's balance sheet continues to balloon at a rate of $65bn/month, which stands in sharp contrast to the ECB's shrinking balance sheet as LTROs are redeemed, thus sending the dollar lower.

FED Balance Sheet Compared to ECB Balance Sheet and EUR-USD Exchange Rate



Sources: RichesFlores Research, Macrobond

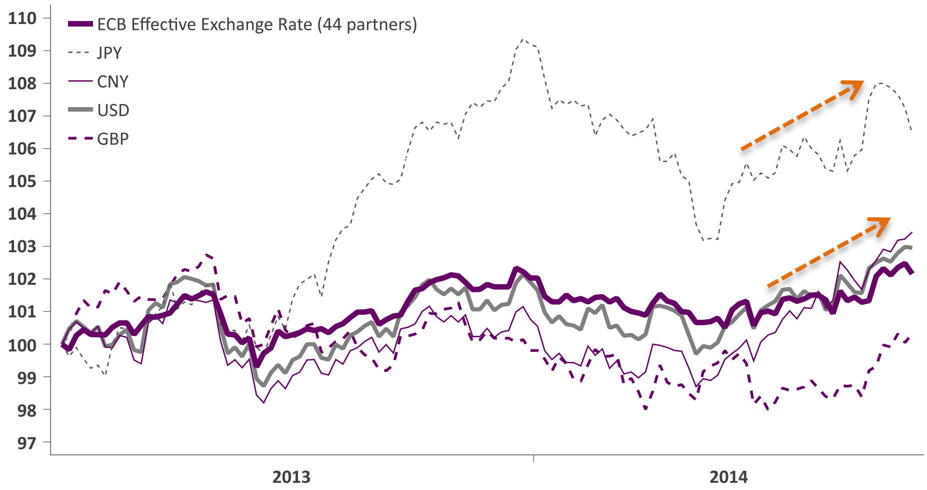
The contrasting trend in the two central banks' balance sheets was not as important last summer when rumors of a Fed rate hike were hogging the spotlight. Now, it seems to have outweighed changes in exchange rates these past few weeks.

2- Secondly, because the euro has not only risen versus the dollar but a host of other currencies, as well. In fact, the single currency has appreciated even further in response to China's recent shift in exchange rate policy and fresh downwards tension on the yen since the start of the year. In fact, yesterday, the

ECB's synthetic exchange rate for the euro versus 44 trade partners reached levels not seen since mid-2011.

Euro Nominal Exchange Rate

October 1, 2013 = 100

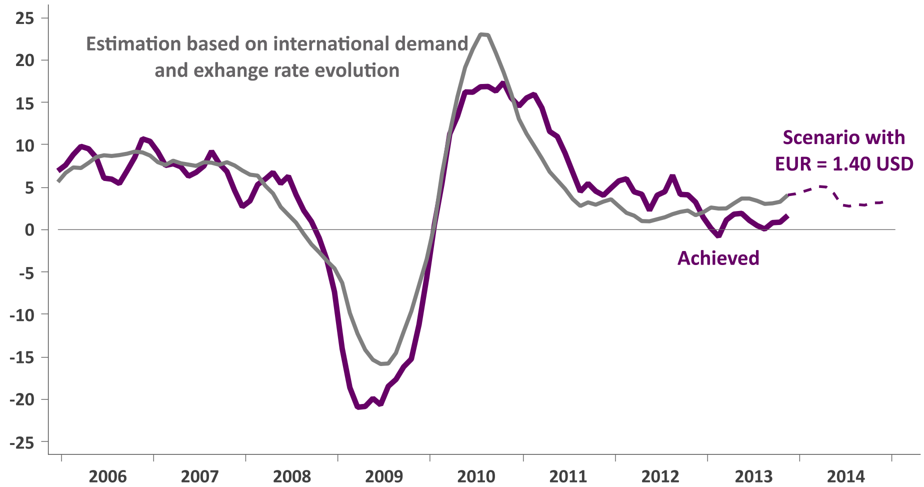


Sources: RichesFlores Research, Macrobond

3- Lastly, because these developments have called into question the strategy the euro area has used to dig itself out of recession. Almost exclusively based on improving competitiveness, the strategy has been undermined by the euro's strengthening...an appreciation it is partly responsible for. Put all these ingredients together and what you have is a starkly deflationary environment which, in addition to hurting domestic demand, does nothing to boost exports. Consequently, the euro area economic outlook is at risk. According to our estimates, if growth in global demand is held constant, the euro, a stable euro at its current rate until year end, would absorb all the positive effects generated by the improvement in the global economy. Export growth would finish the year at the exact same level as December 2013, i.e. less than 2% per year. It goes without saying that these numbers would be even worse if the euro should strengthen any further, which could hijack all hopes of improving the region's economic situation.

EMU Exports Excluding Euro Area

YoY in %, at constant prices



Sources: RichesFlores Research, Macrobond

The ECB will undoubtedly have to intervene one way or another to halt the troubling trend in the exchange rate. It is merely a question of when...and with how much gumption.

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