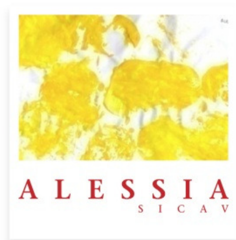


RANDOM NOTE 03/15

Is it time to buy the Euro ?

The effects of the first European QE will be felt at least over the next eighteen months and numerous questions remains open (implementation rules, effects on financial markets and the real economy and possibility of QE2).

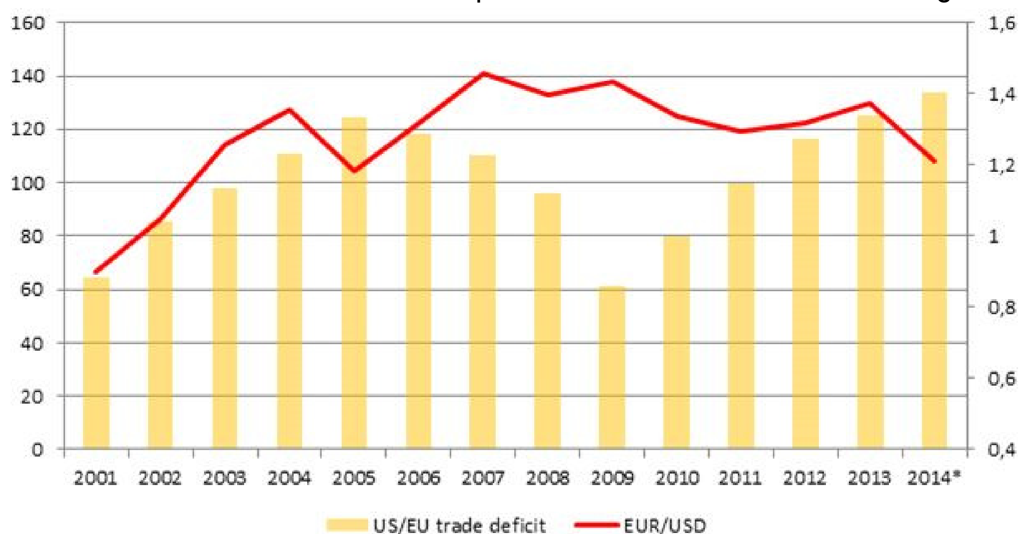
In our view, the real goals of the program are the following:

1. Competitive devaluation thru the depreciation of the Euro against the US dollar
2. Improving the sustainability of the peripheral countries' debt until the reforms produce their effects and European economy recovers.
3. Drive the expectations and sentiment of economic agents, both consumer and businesses.

Has the depreciation of the Euro against the US dollar stopped or will it take a similar path than the Japanese Yen, which lost half of its value in the last three years as a consequence of four QE programs? In our view, the two contexts are different and the depreciation of the Euro will soon be over due to the following factors:

1. **Lower trade deficit and oil effect.**
   The US still have a large trade deficit with the European Union (see Chart1). Expectation of a rebalancing due to the so-called "shale revolution" are threatened by the drop in energy price and European exports should benefit from the devaluation of the currency.

   Chart 1 – Trade Balance between Europe and the US and EUR/USD exchange rate

   Source: US Census Bureau and Bloomberg * Estimations
2. **Interest rate differential.**
   In Europe, the interest rates decline seems to have found its natural limit, even if negative nominal rates remains a possibility. At the same time, in the US, markets have long been prepared to an increase in rates and now all investors are waiting for the first signs of inflation. This results in a 10Y breakeven between stop and forward rates of 10%, which in our view, doesn't justify a carry trade (Long 10Y US Treasuries / Short the 10Y german

equivalents) that would be extremely risky in the event of a materialization of an European recovery.

3. **Possibility of an European Recovery.**
   We acknwoledge that QE has uncertain effects on the real economy, but it could help the structural reforms to produce results and may induce a positive change in consumers and producers expectations. While there is no statisticallly significant correlation, at least in the short term, between the trade balance and the FX level, a devaluation leads to an improvement of the trade balance and ultimately, the GDP. In the fourth quarter of 2014, US exports grew by only 2.8% (a 0.37% contribution to GDP) while imports grew by 8.9% despite the fall of energy prices (a 1.39% GDP contribution). This results in a loss of 1.02% of annual GDP in the favor of the rest of the world. The growth differencial between the US and Europe can narrow down and spark interests in the Euro.

4. **Greek Crisis**
   In our view, Europe is now much better prepared to an exit from Greece than it was back in 2010-2011 because:
   a. Portugal, Spain and Ireland have overcome the crisis and basically solved their problem having made the necessary reforms. Even Italy made some progress.
   b. The backstop mechanisms (EFSF) are now in place.
   c. The banking sector successfully passed two stress tests and Europe has now a single supervisory system for the main continental banks.
   d. Overalll interests rates are now much lower than it was then and European public debt is now more sustainable.
   e. The QE is an additional tool to support peripheral governement bonds.

We should not underestimate the possible dispersion of the "Tsipras effect' that could lead to the rise to power of parties opposed to austerity policies elsewhere in Europe. However the fundamental effect should remain contained because Greece is the only country with Cyprus under an assistance program.

In conclusion, the Euro depreciated against the dollar due to poor economic growth in Europe and to the rising interest rate spread between the two blocks as a result of European QE. On the medium term, more covergent growth rates, trade balances evolutions and reduction of the interest rates differential should at least stop the devaluation.

Luxembourg, 3 February 2015
The Portfolio Management Team

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