Lombard Street Research

LSR Daily Note

March 28, 2017

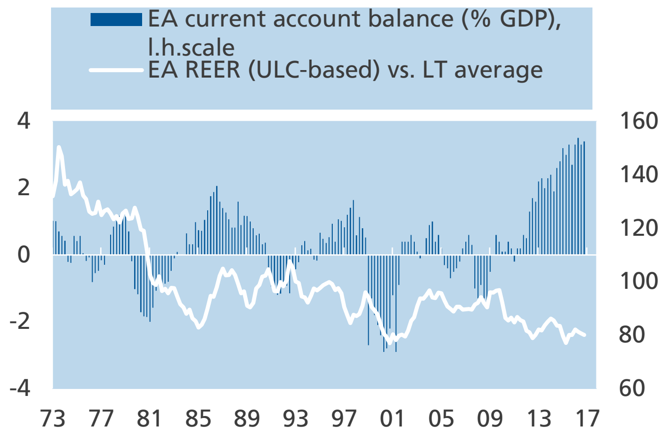
The euro could bounce sharply later this year

- **The euro is about 10% below its long-run fair value based on relative ULCs**
- **Undervaluation persists despite historically high EA current account surplus**
- **The unwinding of large unhedged investment positions could trigger euro rise**

The euro is undervalued. We compare the currency's broad real trade-weighted index, based on relative unit labour costs, with its long-run trend. By this measure, the euro is around 10% below its 'fair value' even though the euro area is running the biggest current account surplus since 1999. Something's got to give. Our bet is on the euro. The trigger for the upswing is likely to be when the market begins to price in a 'proper' taper of ECB QE in late summer. The impact on the euro could be sharp.

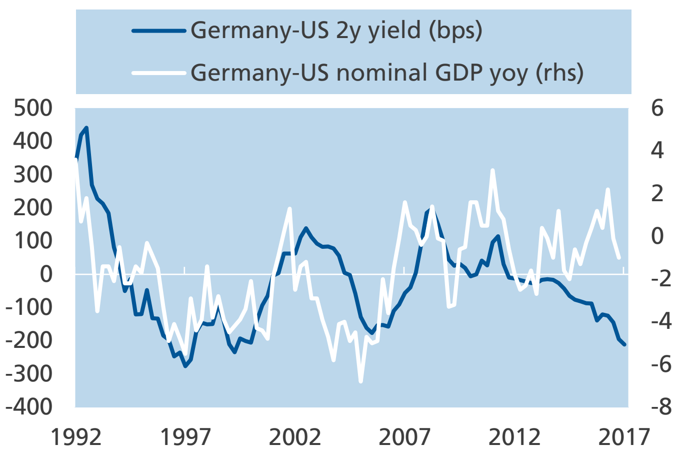
ECB QE has boosted the euro area's competitiveness through a weaker currency while the plunge in energy prices has lowered the euro area's energy import bill. The EA's current account surplus ballooned to a historical high 3.4% of GDP (EUR 363bn) in December. Germany, with a surplus of 8.3% of its GDP, accounts for EUR 261bn of that total, a reflection of the still-persistent structural imbalances within the monetary union. But Germany is not the only country to have improved its external position. Thirteen out the 19 euro area members are running a current account surplus; before the global financial crisis, only seven were. Initially, import compression was behind the improvement, especially in debtor countries. But more recently, gains in external

Surging current account surplus and weaker euro



Source: DS, TS Lombard

Depressed yields holding the euro down…for now



Source: Bloomberg, TS Lombard

competitiveness through price and wage adjustments and a weaker currency have been the driving forces.

The mirror image of the current account balance is the financial account gap. The euro has stayed weak despite the EA's burgeoning external surplus as the ECB engineered a widening of the financial account deficit by means of quantitative easing. QE depressed yields, prompting an exodus of EA investors and the winding down of EA liabilities by non-EA investors. This was expected given the construct of the ECB monetary policy. But what is unusual - and under-appreciated - is that a large part of the outflows into non-EA assets was unhedged. This is in contrast to the flows into EA liabilities. While there is no concrete way of measuring the extent of hedged and unhedged positions, we have a few useful indicators.

Tracking the 'other investment' component of the financial account balance, which largely consists of currency and deposits, is a good starting point (see link). Specifically, if an EA investor buys assets outside the euro zone and decides to hedge their exposure, this is likely to show up as a decline in EA holdings of (other) assets abroad. And vice versa for EA liabilities. Indeed, when foreigners began to unwind their EA liabilities after the signalling/start of ECB QE, their purchases of (other) EA liabilities increased.

But hedging by EA investors of their asset purchases abroad has declined over the last couple of years. This has coincided with the increase in the cost of hedging rose as markets and swap dealers priced in more easing by the ECB. Other structural and technical factors have also been at play (see link). More recently, EA holdings abroad of debt, equities and currency and deposits have increased, suggesting a significant reduction in hedged positions.

To conclude, suppressed EA yields have played a key role in keeping the euro artificially low. But yield differentials are stretched and are ripe for a correction. Weak EA growth drove equity investments out of the EA. But as the recovery unfolds, this pressure is easing. Crucially, because a large proportion of European investors' assets abroad is unhedged, the turnaround in the financial account balance and the surge in the euro, when they occur, may be more potent than many anticipate.

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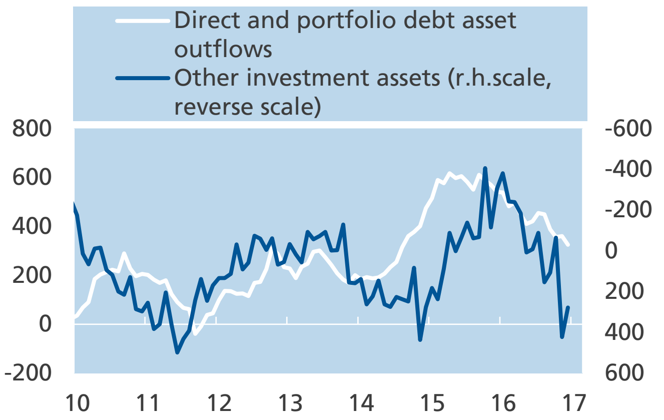
ⓘ Disclaimer

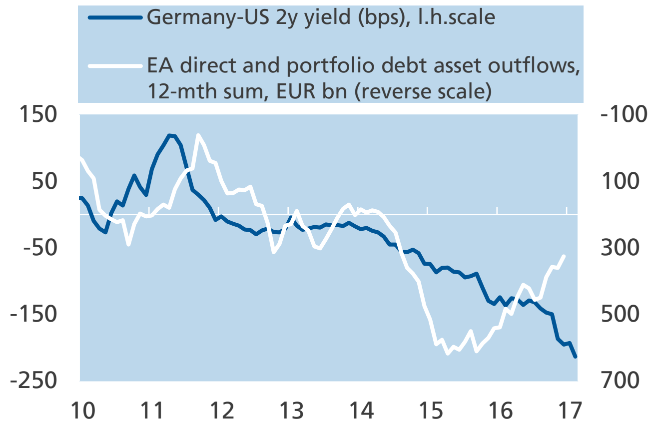
Potentially large unhedged EA asset holdings abroad

12-month rolling sum, EUR bn



Source: DS, TS Lombard

...may cause a sharp swing in the euro



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