Ashdon Investment Management

The Case For A Strengthening Euro

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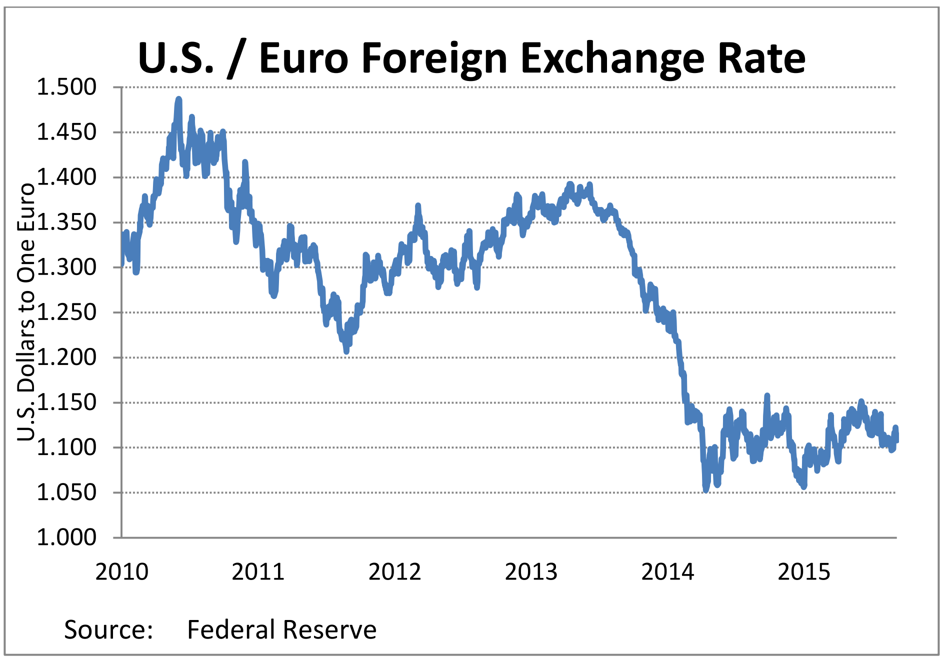
- The Euro-area economy, even with its large list of weaknesses, has actually been a strong net exporter since 2012.
- A growing trade balance in the Euro-area is a reflection that more companies are exporting than importing, due to relative "cheapening" of goods and services. This difference creates a growing price arbitrage, and ultimately more demand for the EUR.
- The US manufacturing, oil & gas and mining sectors are under pressure, and arguably heavily influenced by the strength of the USD.
- We believe the export strength in Europe combined with the weakness in exports and energy sectors in the US, means that the USD could weaken and the EUR could strengthen naturally overtime.

The Case For A Strengthening Euro

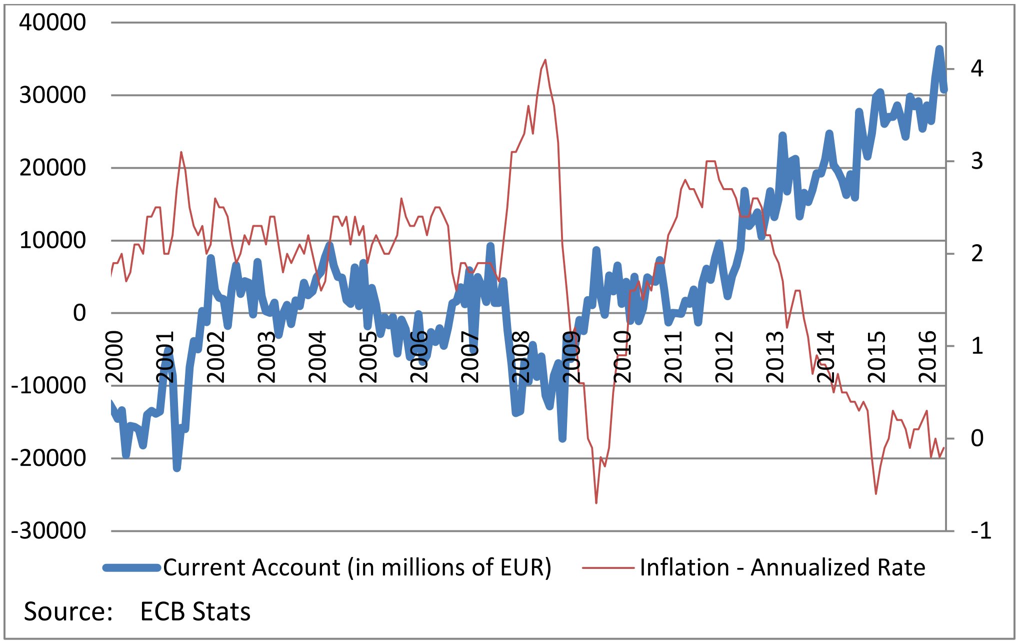
Investor consensus is that the US Dollar (USD) will continue to strengthen. The position is defendable because the FOMC has consistently communicated that the US is on a path for interest rate increases due to economic strength, measured as full employment and modest inflation. Meanwhile, other central banks around the globe have a stance of monetary easing, or lower interest rates. This is because high levels of debt have hampered growth, and threatened widespread deflation in those regions.

This divergent central bank policy has been driving exchange rates since 2014. A currency pair that significantly reflects this directional bias is the USD/EUR. A consensus fair value estimate for the EUR after policy adjustments was (is) roughly 1 to1 with the USD. The spot rate came close to this value at the pair's bottom in 2014 of $1.05/EUR, and had a subsequent "re-test" in 2015.

We believe this directional bias of the USD is potentially wrong. To asses this we will look at the fundamentals.



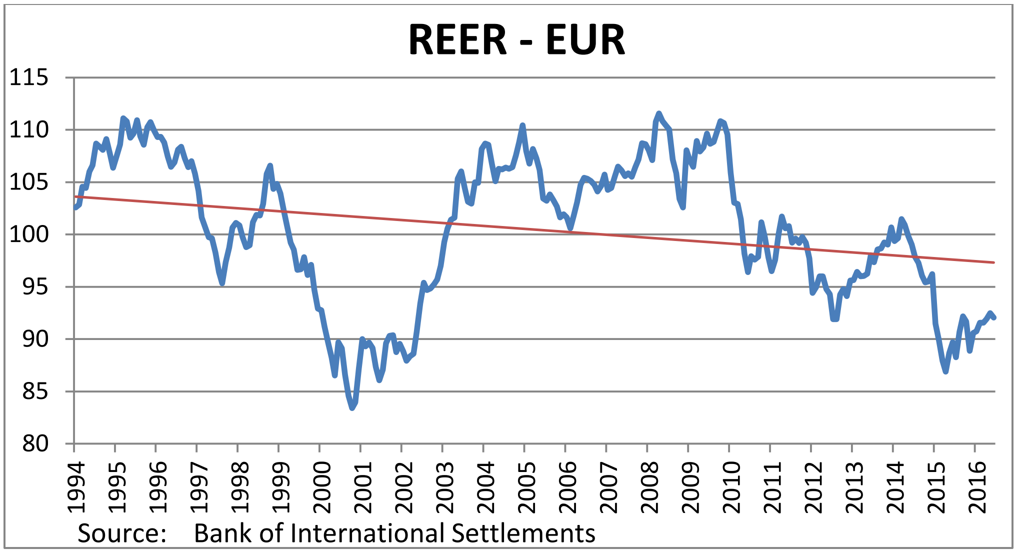
The Euro-area economy, even with its large list of weaknesses, has actually been a strong net exporter since 2012. Currently, the trade surplus is creating a current account surplus of close to 30B EUR per month. The Surplus is growing.



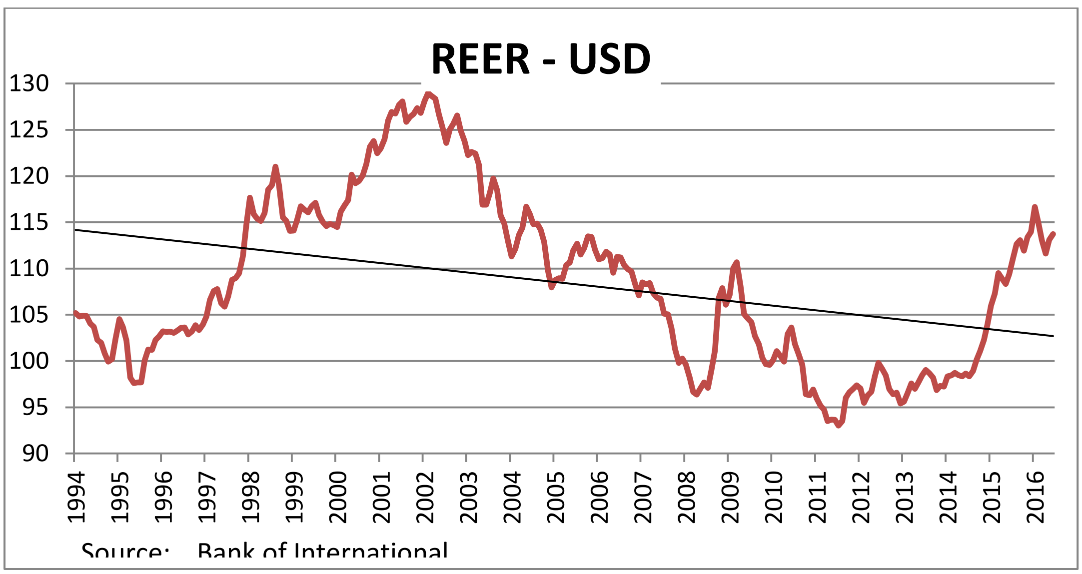
The Euro-area inflation rate is plotted in the chart above. Since 2012 the Euro-area has experienced a significant decline in inflation, actually dipping into deflation in the first quarter of 2015. Meanwhile, even though US inflation hasn't reached the FOMC's 2% target, the inflation rate has remained positive.

As with any market, the forces that move prices (exchange rates in this case) ultimately come down to supply and demand. A growing trade balance in the Euro-area is a reflection that more companies are exporting than importing, due to relative "cheapening" of goods and services. This difference creates a growing price arbitrage, and ultimately more demand for the EUR.

Supporting evidence of competitive export prices can be found in the chart below; the trade-weighted index of the EUR with inflation (deflation) taken into account. This is also known as the Real Effective Exchange Rate (REER). It is a good indicator of net prices of goods and services relative to trading partners' prices. The long term trend level indicates that the REER is declining, as indicated by the trend line.



Compared to the EUR, the USD REER is above its apparent trend level and seems expensive.



REERs tend to self-correct over time as businesses compete away easy savings. However, trade imbalances (partly caused by swings in REERs) can persist over long periods due to other influential factors, such as inflation expectations, GDP growth and government budget deficit/surplus.

Because of the divergent interest rate policy mentioned above, the US manufacturing, oil & gas and mining sectors are under pressure, and arguably heavily influenced by the strength of the USD. As highlighted in our Q2 2016 Economic Commentary, the potential for spill-over weakness into different areas of the economy is elevated each day those sectors become weaker. Raising interest rates at this point could slow the US economy, potentially creating a recession. The FOMC is well aware of this predicament.

We believe the export strength in Europe combined with the weakness in exports and energy sectors in the US, means that the USD could weaken and the EUR could strengthen naturally overtime. However, a catalyst could speed up the move. For example, market participants who expect the FOMC will raise interest rates could become disappointed if the FOMC communicates further reluctance to do so. Should market participants believe the FOMC could actually *lower* rates, we believe this convergent policy would have the same effect as the prior divergent one in 2014, only this time the other way.

The risk to reward of holding EUR versus the USD looks intriguing in our view.

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