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MARKET VOICE

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Why have EURUSD and Rate Spreads Gone in Reverse Gear?

For much of the past decade deflation has been the bogey man of the U.S. and many other markets and this was true even as the U.S. Federal Reserve (Fed) began to unwind quantitative easing and nudge Fed funds away from zero in the closing months of 2016. But concerns pivoted in 2017 away from deflation towards a building threat of inflation reflecting the expectations – and ultimate reality – of a surge in U.S. deficit spending at the same time unemployment was dropping to record lows. The prospect of rising inflationary pressures is reflected in a roughly 1 percentage point rise in the U.S. 2-year Treasury rate over the past year as the market priced in additional Fed tightening.

While European growth prospects have recently improved, the continent is still faced with deflation and the European Central Bank (ECB) policy rates remain in negative territory. European 2-year government rates (proxied by Germany) remain close to levels seen a year-ago. The divergence in U.S. and European rate paths opened up a substantial yield advantage for the USD vs the EUR. Conventional wisdom would argue higher relative rates should strengthen the USD and historical experience would support this presumption

But as reported in a Reuters article: "With correlations between interest rates and currencies approaching their lowest levels in more than a decade, investors are pondering whether the traditionally dominant driver for foreign exchange markets remains relevant. In usual times, currencies can rise and fall according to the differences in interest rates between economies… But since the third quarter of 2017 and particularly in the opening weeks of the year, that correlation has broken down sharply between the dollar and some of its major rivals, notably the euro EUR=. That signals other forces are dominant. Ninety-day correlations between the difference in 2-year U.S. and German interest rates and the euro/dollar rate are near their weakest levels since late 2005, according to one widely-used measure." As shown below, an unusual link emerged over the past year between rate spreads and EUR performance and it is our intent in this month's Market Voice to determine why EURUSD is moving in reverse gear with respect to rate spreads.

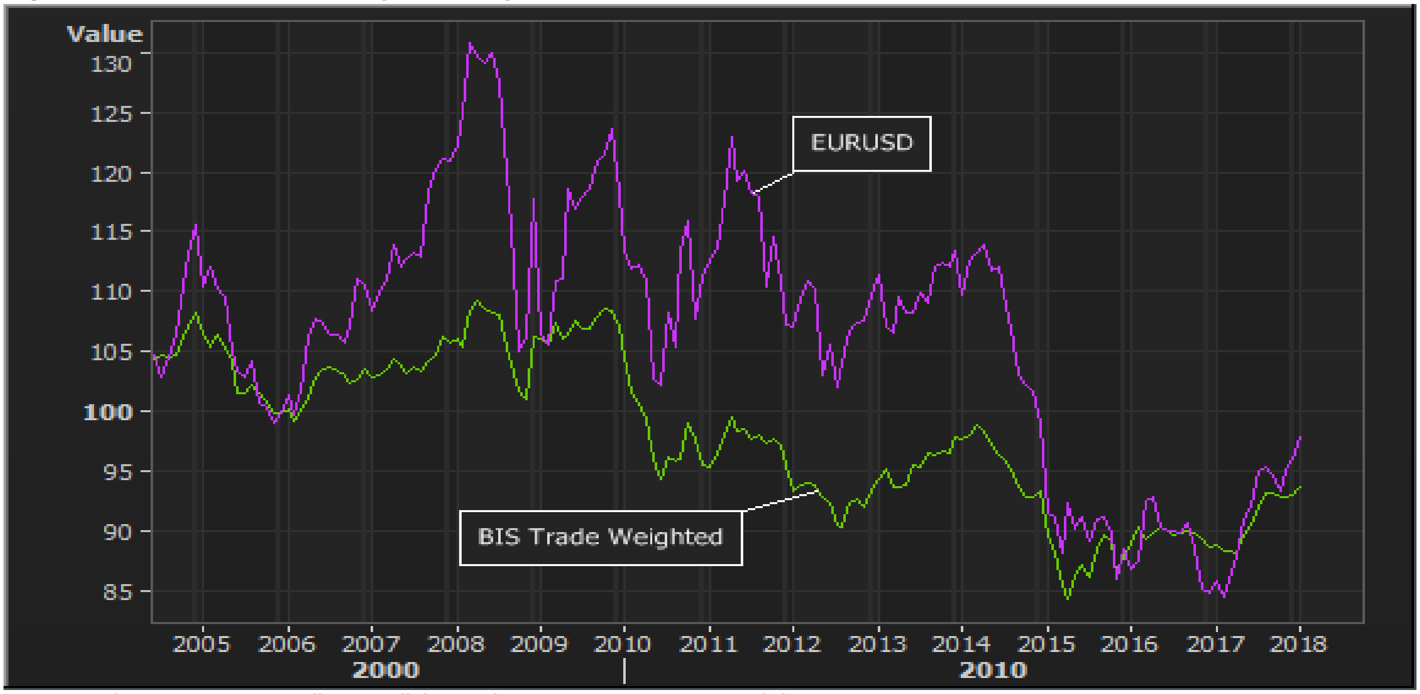
Figure 1: USD vs EUR 2-Year Rate Spread and EURUSD

Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

Is it because the EUR is Cheap?

One potential explanation for the EUR rebound is that it is unusually cheap. Figure 2 suggests that weak real valuation could have been a factor at least in providing a bottom for the currency since the 2015 bottom emerged as the EUR in real terms was sinking towards the lows established in its early days of trading. While low real valuation is a compelling basis for the currency finding support, it is less clear as an explanation for a rebound. In any event, the EUR is now approaching mid-range for real valuation so if further strength is going to emerge it will have to come from elsewhere.

Figure 2: Real EUR Valuation (1999=100)



Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

Could it be Chinese Buying?

It was reported in January that the Chinese government was going to cease buying U.S. Treasuries to contain exposure to the US market and the Bank of Japan and possibly other Asian governments are also cutting back on US Treasury purchases. In addition, the Chinese central bank now targets the CNY against a basket of currencies instead of solely the USD. It is possible that general dollar weakness is forcing them to buy other currencies – including the EUR – to keep the CNY stable against the basket and this may be a factor buoying the EUR against the negative pull of rate spreads.

Figure 3 suggests there may be some connection between Chinese foreign exchange policy and the uncharacteristic EUR rebound. Considering that the EUR bottomed against the CNY simultaneously with the USD is not surprising given that the Chinese central bank has a policy of targeting the CNY against a basket of currencies. But it is notable that the EUR's recovery against the CNY leads its rise vs the USD – one would expect the USD axis to lead if the relation was purely a passive response to central bank management of the USDCNY level. It is also worth noting that the EURCNY cross peaked in the middle of last year so if this was a factor behind the EUR rise, it is no longer providing support.

Figure 3: EURUSD and EURCNY Daily Closes

Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

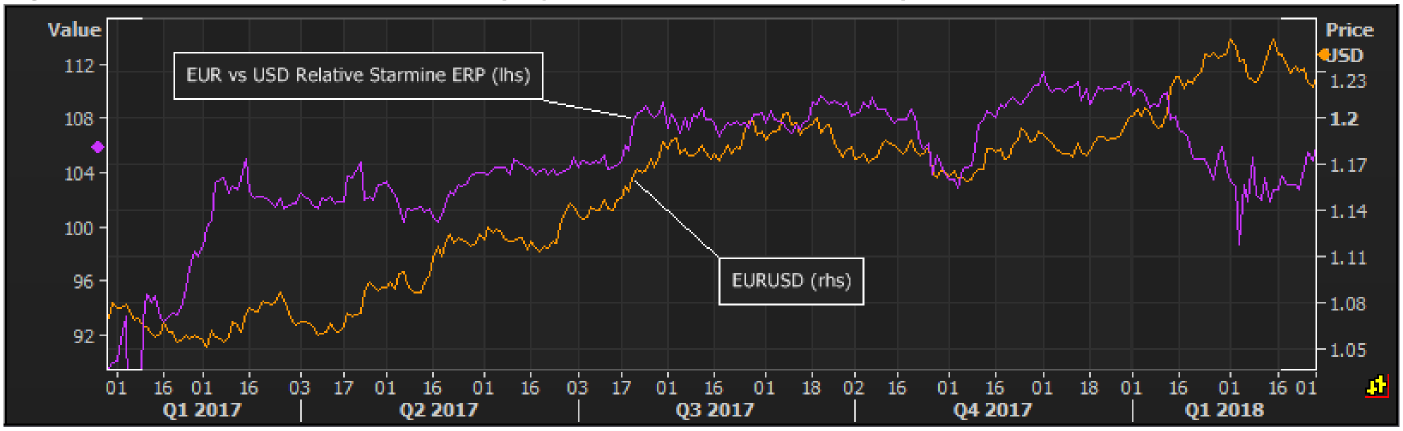
There are Asset Classes Other than Interest Rates

The EUR has been rising in the face of a negative interest rate outlook. This can possibly be explained by a combination of the EUR hitting super-cheap real levels last year and some central bank reserve rebalancing away from the USD. But as was shown above it appears that these are at best now fading sources of support for the currency. If the EUR is to motor yet higher, there will have to be other sources of support.

While interest rate spreads are traditionally seen as the primary driver of cross-border capital flows, funds are also deployed across borders in response to varying opportunities in equity markets. Eikon's Starmine database has estimates for the risk premiums embedded in equity markets for most countries. We have taken their estimated premiums for the countries within the Eurozone and have aggregated them weighted by relative GDP. We can use the risk premium for the broad Eurozone aggregate against the U.S. premium as a proxy for the relative attractiveness of the two markets and see if this helps explain the EUR's unusual strength.

Figure 4 indicates that for much of the past year, growing attractiveness of the embedded return in the European stock markets relative to the U.S. market might have been substantial enough to allow the EUR to rally in the face of an adverse interest rate environment. But the relative attractiveness of European equities seemingly started to erode at the end of last year. We can question whether the remaining return advantage will be sufficient to drive the EUR higher, or ever to support it at current levels.

Figure 4: EURUSD and The Starmine Equity Risk Premium for the European vs U.S. Stock Markets



Source: Thomson Reuters Eikon

Is the EUR Rally Over?

It seems there are three factors that justify the EUR rebound in the face of adverse interest rate movements: it was cheap, at least some central banks were buying and equities were attractive. But it appears that all three of these factors are at best sources of support but not further strength. Figures 5 and 6 indicate that as the EUR strengthened speculative positioning became heavily skewed long EUR. Specifically, figure 5 shows that speculative net longs in EUR as reported by the CME are at five-year highs and coincident to that the skew for 25-delta EUR calls vs puts is also at an extreme. Consistent with the option skew, figure 6 shows that cumulative net option buying over the past three months shows a heavy bias for buying EUR calls vs puts.The implication is that exposure is heavily lopsided in favor of the EUR which suggests that a compelling incentive will be required to draw still more long exposure.

Figure 5:

Speculative Net EUR Buying and 25D Risk Reversal

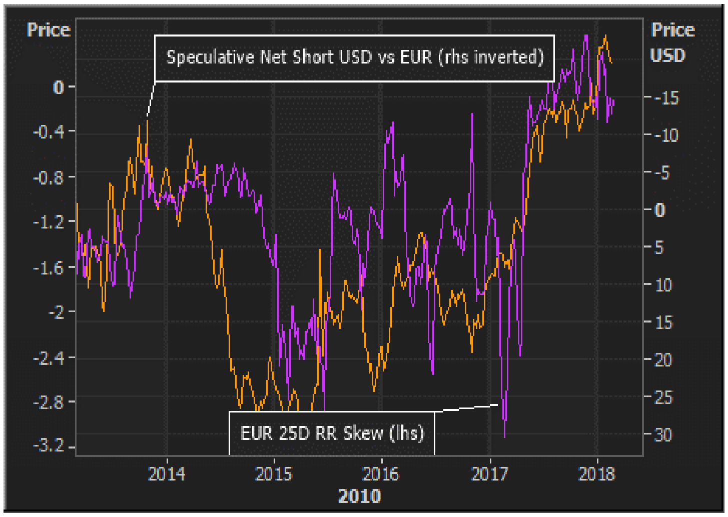
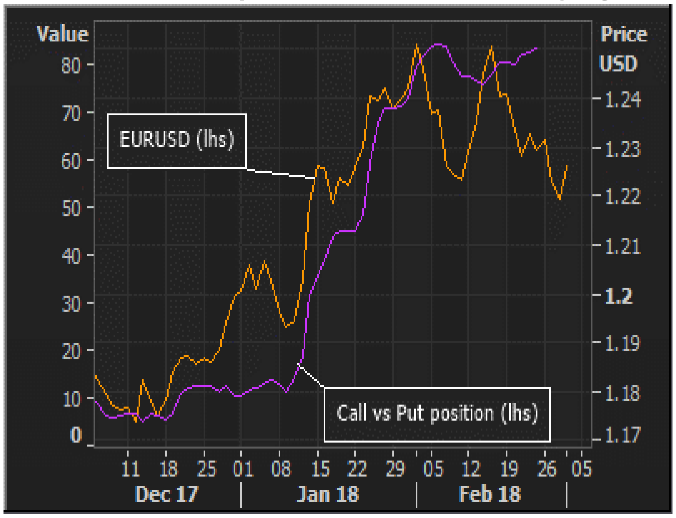


Figure 6:

EUR and DTCC Reported Net Call vs Put Buying



Source: Thomson Reuters Eikon – Click on Chart to Request a Free Trial

The Bottom Line

The historic relation between rates and EURUSD indicate that the widening of the USD interest rate advantage over the past year should have caused the EUR to weaken. Instead, the EUR has rebounded almost 20%, hitting its strongest level in three years. We have identified three possible explanations for this unusual pattern:

1) The EUR was historically cheap in real terms when it bottomed
2) Central bank – especially China – diversification away from the dollar may have been a source of strength
3) The relative value of equity markets may have been compelling enough to overwhelm the negative rate picture

While there may yet be other reasons for the EUR strength, as far as we can establish the above sources have exhausted their potential to propel it higher. Look out for a continuation or amplification of those factors. Failing that, there is risk for EUR longs to be caught off guard by a rapid correction in EURUSD catching up with the rate differential trend.

Market Voice

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