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Il Sole 24 ORE

Mini-euro helps exports (a little)

Dollar driven by speculation, but EU currency underpinned by fundamentals

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A word of advice for Italian and European exporters: don't entertain too many illusions about the recent sudden weakening of the euro against the dollar. It might just be a temporary blip. The fall in the exchange rate from the 1.2374 of 18 April to yesterday afternoon's [27 April] low of 1.2056, which translates into a 2.57% weakening of the single currency, could be short-lived. Because for the time being it's the result more of an adjustment in speculative portfolios, caught off guard by the bound taking the yields of US treasury paper over 3%, than of a true change of views on the market. So in the medium term the trend could be reversed again: the fundamentals of the economy still seem to be pushing from the other direction. In other words, towards a strengthening of the euro. Or at any rate, not towards a weakening

The reasons for the U-turn.

Until just a few days ago speculators were betting on a weak dollar and strong euro. This is illustrated by the figures from Bank of America, which show that the downwards betting on the dollar was the second most common speculation on the financial markets. Further confirmation comes from Commodity Futures Trading Commission data, which indicate that bullish speculation on the euro, through futures, hit all-time highs. Even institutional investors are moving in the same direction, as shown by an indicator developed by Amundi and updated to 24 April. Amundi's indicator suggests that the dollar is the most under-weighted G10 currency in portfolios and the euro the most over-weighted. In short, everyone's placing their bets on the super-euro and the weak dollar. Or at least they were doing so until just a few days ago.

But this week an event occurred that re-shuffled all the cards on the table: the yield on 10-year US government paper rose to over 3%. This restored the appeal of US bonds, creating an unexpected flow of capital to the American market. The dollar therefore rose in price against all the other currencies, euro included. And so many investors who had been betting down on the dollar were wrong-footed and had to take steps to remedy the situation – by buying dollars. But there's more. "Thursday 26 April, 16:00 hours was the deadline for a number of put options on the euro/dollar, with an exercise price of 1.22 for a sum of 5 billion", recounts Andrea Fioravanti, a portfolio manager specialising in currency, speaking from London. "This removed a sort of cap that had been holding the single currency anchored at that level", explains Fioravanti. It's no coincidence that in just 20 minutes, from precisely 16:00 on Thursday, when Draghi had already finished speaking, the euro plunged from over 1.22 to

1.2104. All of this confirms that the fall of the single currency this week was fomented by speculation, which is short term.

The reasons for the strong euro.

If we look at the fundamentals, which drive the markets in the medium term, the story looks different. Many factors seem to be leading to a strengthening of the euro. Or at any rate, not towards a weakening. The first is Donald Trump's fiscal policy. The market believes that it could overheat the US economy in 2018, creating debt and deficits for the future. This historically has a depressive effect on the dollar.

The second reason is linked to the central banks. It's true that the Fed is raising interest rates (which should increase the dollar's appeal). But it's also true that the market is looking ahead: the ECB too will raise interest rates sooner or later. So this benefits the euro. And then there's a third reason keeping the single currency buoyant: the US trade deficit with respect to Europe. And a fourth: central banks in the emerging countries are still under-exposed to the euro. As Fioravanti explains: "This creates a demand for the European currency". These are all sound reasons to believe that the euro will again appreciate. That's the view of Monica Defend, head of strategy at Amundi. "According to our equilibrium models, even if the euro rose to 1.24 the dollar would still be under-valued. Just imagine now, with the exchange rate at around 1.21".

The reasons for the weak euro.

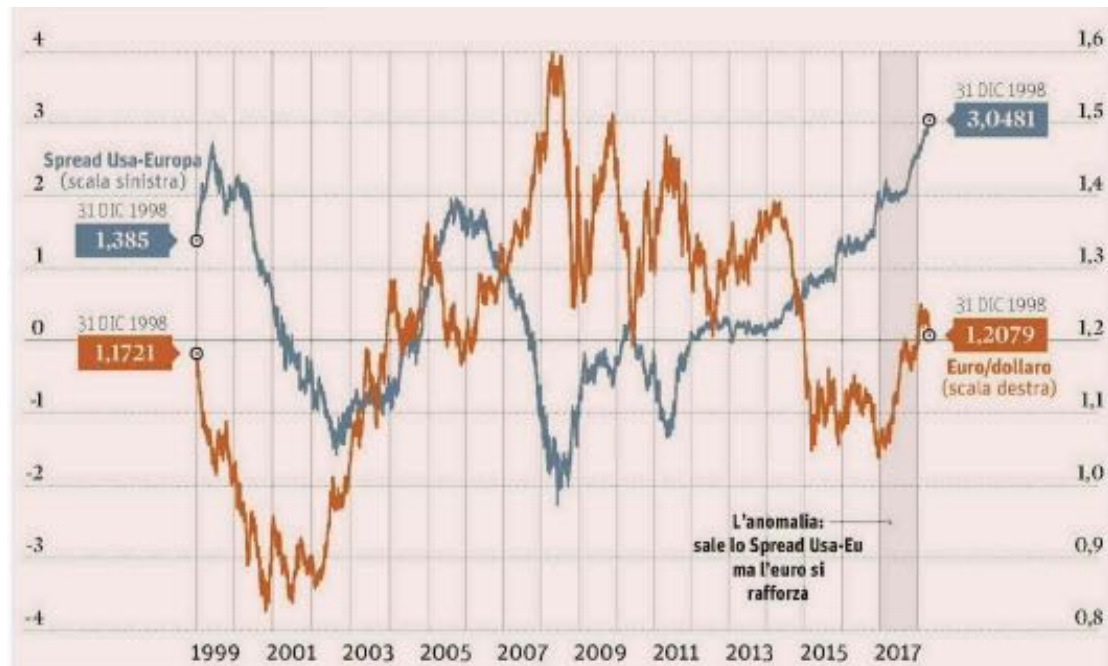
But there's actually a reason that would explain a weakening of the euro: the fact that in the US interest rates are considerably higher than in Europe should drive capital flows to America, and cause the dollar to appreciate. "At present, on 2-year maturity the spread between US and European government bonds is more than 3%", observes Francesco Castelli, CFA at Banor Capital. The last time the rates differential was this high, the euro was indeed very weak".

But some commentators feel that this mechanism no longer works very well. "Rates are distorted by the central banks", observers Defend. "That prevents the normal 'hydraulics' of the markets from working, so currencies are moving without really taking this factor into account. The classic paradigms are no longer working". Moral of the story: in the scales of the euro/dollar exchange rate, it seems that the side with the reasons for a strengthening of the single currency is the heaviest. That's what some commentators think... but not all of them. Some, like HSBC, have revised their euro/dollar estimates downwards. Not least because if the EU economy were to slow for real, then the fundamentals could again lean towards a weak euro.

The euro-dollar tug-of-war

US-EUROPE RATES DIFFERENTIAL AND EXCHANGE RATE WITH EURO

Trend in the spread between 2-year US rates and 2-year German rates, compared with the trend in the euro-dollar exchange rate

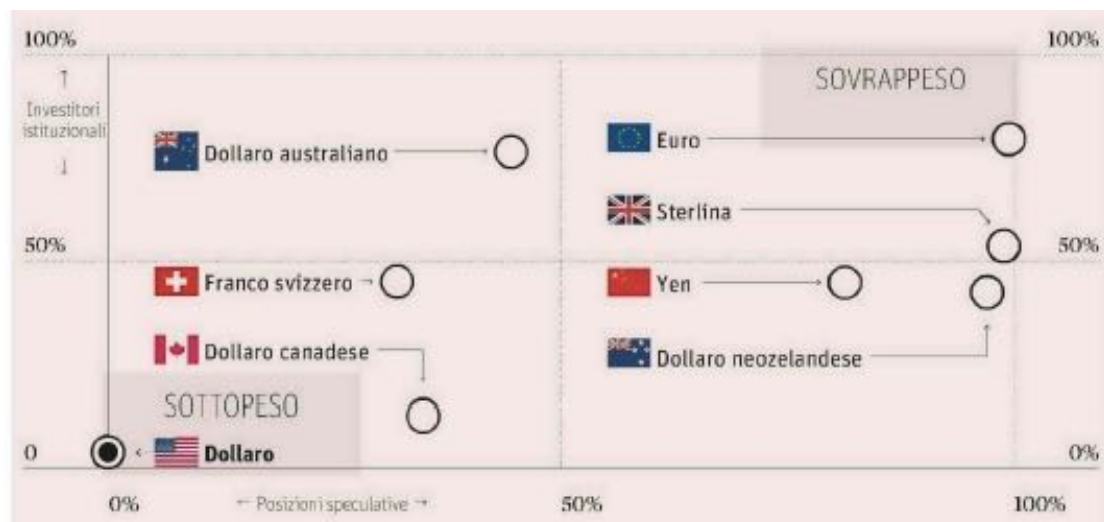


US-Europe spread (left axis) – Euro/dollar (right axis)

The anomaly: the US-EU spread is widening but the euro is strengthening.

INVESTORS' POSITIONING

Over-weighting and under-weighting by institutional and speculative investors on G10 currencies. Percentage data with respect to the last 5 years.



Sources: Bloomberg; calculations by Amundi