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EUROPEAN MARKET COMMENT: THE EURO

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The inaugural years have proven to be a tough ride for the €, with the currency weakening 22.6% against the US$, 18.4% against the yen, and 11.3% against the £ between its January 1999 inception and the end of August 2001. On a trade-weighted basis, the € has depreciated 14.7%. However, July and August appear to have brought signs of a trend reversal, with the € strengthening 3.8% on a trade-weighted basis and 7.3% against the US$. The recent rally has led to speculation that the € may be embarking on a prolonged bull market.

The US$ has appreciated significantly relative to euro-zone currencies since 1995, largely benefiting from a surge in euro-zone investment, both in the form of portfolio flows and direct investment. BP's purchase of Amoco, Daimler's purchase of Chrysler and other major transactions led to demand for hundreds of billions of US dollars. In theory, recent US$ weakness reduces the cost for euro-zone companies to acquire U.S. companies, suggesting that the current environment could lead to greater foreign direct investment inflows to the United States. However, this is unlikely given that many euro-zone firms are coming off a massive investment binge in the United States, and the next few years will likely be spent integrating/digesting their U.S. operations.

The recent strength of the € relative to the US$ is also based on relative economic prospects and the relative attractiveness of assets in both markets. Euro-zone economic fundamentals are not impressive, particularly in Germany, which accounts for a third of the region's GDP. However, relative to the United States, the recent trend has been favourable. Since June of last year, U.S. growth has slowed from 4.4% to 1.2% year-on-year, whereas euro-zone growth has only slowed from 3.3% to 1.7% thanks to strong household consumption. The outlook for the U.S. economy was deteriorating prior to the terrorist attacks in the United States and the uncertain impact of recent events on consumer confidence will be critical in measuring the extent and protraction of the downturn.

The outlook for the €/US$ exchange rate clearly hinges on the relative strength of the U.S. and euro-zone economies, and the outlook for relative capital demand in particular. The most rational explanation for the recent € strength has been the change in expectations on the timing and strength of the economic recovery in the United States, and downgraded expectations for the trend growth rate, and return on assets. At present, eight of the ten largest investment banks believe that the € will hold or extend gains from this rally.