CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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"Euro Heading for Parity"
by Jonathan Loynes, Capital Economics, May 17, 2010

Concerns about European sovereign debt woes have spiked fears about the future of the Eurozone and its single-currency system. After evaluating factors that support the euro's appreciation in light of those that suggest further depreciation, the authors conclude it is likely that by 2011 the euro will be at parity against the U.S. dollar.

Concerns about European sovereign debt woes have spiked fears about the future of the Eurozone and its single-currency system. While some of the forces bearing down on the euro over recent months may be easing, despite the recent plunge of 17% against the U.S. dollar, there are plenty of other reasons to expect the currency to fall further.

Why would the recent downward path come to an end? First, European sovereign debt woes have placed increasing downward pressure on the Euro, but the European Union's €750 billion bailout has relieved fears of a near-term Greek default. The five-year Greek credit default swap (CDS) premium fell approximately 443 basis points from May 6 through May 12. Since October 2009, the euro and CDS premiums of Greek debt have held an inverse relationship, but with premiums retracting, the euro has yet to respond. Secondly, the euro has tracked interest rate expectations for the Eurozone and United States until early 2010, at which point the two diverged. Given that Eurozone rates are expected to exceed U.S. rates for the near future, this might actually suggest a renewed appreciation of the euro against the U.S. dollar. Finally, there is some optimism that the decline of the euro has already been sufficient to provide exporters with a major boost, reducing the need for further depreciation.

While these factors cannot be dismissed entirely, there are still persuasive counterarguments for additional depreciation. First, while interest rate differentials may not undermine the euro, growth differentials will not be supportive. Economists have been decreasing their Eurozone growth projections (compared to the United States) in 2010 and 2011. Second, on fundamental measures such as purchasing power parity (PPP), the euro still looks overvalued, raising doubts over whether the depreciation has been sufficient to give those economies the necessary boost to their competitiveness. Finally, concerns about the single-currency system may have just begun and will continue to weigh on the level of the exchange rate. The recent bailout package has temporarily relieved concerns (as witnessed by the drop in five-year Greek CDS premiums), but fiscal consolidation is still required, and it is unknown if doubts concerning the future of the single-currency region will persist.

In summary, while it is evident that the euro could turn around and appreciate, it is more likely that the depreciations have just begun and the currency has further to fall. Given the afore-mentioned concerns, it is likely that the Euro will hit $1.10 by the end of the year and fall to parity by the end of 2011. This may shock some, but it should not be forgotten that the euro spent its first several years below parity, and with the possibility of the end of the euro looming, there is no reason it should not fall to similar levels.

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"Is Sterling a Buy?"
by Emin Baghramyan, BCA Research, May 14, 2010

Although many investors remain bearish on the pound, most of the commonly cited negatives (e.g., poor public finances, loose monetary policy) have already been discounted by the recent depreciation in sterling. Further, these factors, while troubling on an absolute basis, appear much better in relative terms. The U.K. economy, for instance, is in much better shape than the Eurozone and Japan. Thus, the pound may rise particularly sharply against both the euro and the yen.

The U.K. pound has been in a bear market for nearly three years, having dropped 27% in trade-weighted terms from its 2007 peak. Despite this sizeable downside move, many investors remain bearish on the currency. Much of the pessimism has focused on the state of U.K. public sector finances. Indeed, tax revenues have collapsed in the wake of the deep recession and government expenditures have soared, driving the budget deficit to 11.6% of GDP. The deterioration of the U.K.'s fiscal position, however, appears less alarming on a relative basis, which is more important for currency markets. First, the starting point of the U.K. government's debt profile is considerably lower than its G7 counterparts. Indeed, both the U.K. gross and net debt levels as of 2009 were lower than in the Eurozone, Japan, and the United States. Second, the U.K.'s net debt-service ratio is in line with the rest of the industrialized countries. Third, the maturity profile of U.K. government debt is one of the most favorable, with an effective duration of nearly nine years. The effective duration for U.S. Treasuries, on the other hand, is just above five years, while the Eurozone and Japan are roughly six and seven years, respectively.

In addition to poor public finances, investors have also cited loose monetary policy and the weak British economy as bearish factors for the pound. Although the Bank of England's (BOE) response to the financial crisis has been unprecedented, including near-zero interest rates and quantitative easing (QE) measures, there are several reasons to believe it will begin to tighten policy much earlier than the market is currently discounting. First, the housing market appears to be recovering, as prices have increased by 11.6% from their February 2009 trough. Second, inflation is accelerating, most notably at the core level. Third, the U.K. economy is likely to stage a stronger economic recovery than most investors anticipate, especially relative to the Eurozone and Japan. Indeed, the pound's prior weakness could quicken the recovery, as the U.K. economy is heavily concentrated in trade. Finally, the U.K. current account balance will likely continue to narrow. British exports have been booming since mid-2009, an improvement that has clearly been aided by the cheapened currency. The current account deficit is now just 1.3% of GDP, down sharply from 3.4% in early 2007.

Political uncertainty is also starting to clear up following the recent elections. The Conservative-led coalition government should be more inclined to deliver the necessary austerity measures in the United Kingdom than the alternative Labour and Liberal Democrat options. To enter the coalition, the Liberal Democrats succumbed to major economic policies and fiscal responsibility programs. Further, Labour is unlikely to put up much resistance in terms of tackling the budget deficit. During the campaigns, for instance, both parties proposed tax hikes and pledged to reduce the deficit by half through spending cuts in the intermediate term.

Going forward, there is increasing evidence that sterling could embark on a considerable upturn. The BOE will likely raise policy rates much earlier than the market is currently discounting, thanks to a strong rebound in the economy and infla-

tionary pressures. On a PPP basis, meanwhile, the pound is massively undervalued and could rise particularly sharply against both the euro and the yen. Indeed, the euro area economy is plagued with the debt-deflation crisis in peripheral economies (e.g., Greece). The Japanese economy, meanwhile, remains trapped in deflation that has no end in sight, as the Bank of Japan remains reluctant to reflate asset markets and actively engage in quantitative easing.

"Euro/U.S. Dollar After the Stability Package" by Goldman Sachs, The Global FX Monthly Analyst, May 2010

Despite the sovereign debt crisis in Europe, the bear case for the euro may be a lot weaker than many people realize. The crisis will have less of an impact on Eurozone growth rates than is expected, as peripheral fiscal consolidation is offset by fiscal expansion in Germany. In addition, many euro bears overlook the weaknesses of the United States and its need to fiscally consolidate. The winding up of stimulus efforts in the United States and external imbalances will curtail growth, which in turn should create a drag on the U.S. dollar. This is not to say there are no downside risks for the euro; political risks are elevated and already-reduced growth forecasts could still disappoint.

One of the most important questions the foreign exchange (FX) markets currently face is how the measures taken to address sovereign debt crisis in Europe will affect the euro. The bear case for the euro may be a lot weaker than many people realize, for two reasons. First, the impact of the crisis on Eurozone growth rates will be less than expected; peripheral fiscal consolidation will be offset by fiscal expansion in Germany. Second, many euro bears overlook the weaknesses of the United States and its need to fiscally consolidate. The winding up of stimulus efforts and external imbalances will curtail growth, which in turn will create a drag on the U.S. dollar. This is not to say there are no downside risks for the Euro; political risks are elevated and already-reduced growth forecasts could still disappoint.

Fiscal policy affects FX rates through two channels. The first is that fiscal expansion leads to higher relative interest rates, which should lead to currency appreciation. The second is that reduced debt burdens lead to lower risk premiums, which allow asset prices and currencies to rise. Elevated debt burdens can lead to a powerful reversal of this mechanism. While fiscal expansion is positive for asset prices and thus the currency, these dynamics can be more than offset by concerns over debt sustainability. Interpreting the recent stabilization packages announced in Europe as substituting one transmission channel for the other would be a mistake. Reducing the risk of insolvency for peripheral countries via the backstop facility does not mean the currency will be weakened by more fiscal tightening and quantitative easing.

An analysis of the implications of fiscal tightening indicates that claims of a massive Eurozone growth slowdown are overstated. Greece, Ireland, Portugal, and Spain together account for just 18% of Eurozone GDP. The fiscal tightening that has been announced for these four countries may reduce the Eurozone GDP growth rate in 2010 by about 0.49 percentage point (ppt). In contrast, Germany's fiscal easing alone in 2010 will boost Eurozone GDP growth by about 0.48 ppt. Looking at all 16 countries in the Eurozone, the latest European Union commission forecast is that cyclically adjusted primary fiscal balances will boost Eurozone GDP growth by 0.22 ppt next year. Even if all four peripheral countries were to push for truly savage fiscal consolidation, the net impact on the Eurozone GDP growth rate would still be less than 1 ppt. Compare this with trend GDP growth rates of 2.0% to 2.5% and it

becomes clear that funding concerns will have a limited impact.

The European Central Bank's announcement that it will buy Eurozone government bonds in the secondary market should not be interpreted as QE that will weaken the currency. First, QE is a rather theoretical concept considering the vast amount of cash the financial sector is already sitting on. Second, correlations between movements in QE and FX rates are very weak at best. The QE by the Federal Reserve in the United States and the BOE has been of a far greater magnitude, and not resulted in weaker currencies. Finally, the ECB has announced any bond purchase will be fully sterilized. On balance, therefore, the ECB purchases should be construed as helping to reduce the fiscal risk premium, boosting the exchange rate.

Investors may be becoming too bearish on the euro because they have tended to focus too exclusively on developments in Europe, ignoring the other leg of the exchange rate. Growth in the United States may disappoint relative expectations of growth in Europe. This is partially due to the size of government stimulus in the United States relative to Europe; U.S. stimulus has been much greater and will need to cut back more aggressively during the remainder of 2010. It is also due to the composition of European industry versus that of the United States. Industry in Europe may receive a delayed boost from an inventory cycle that is already fading in the United States. European industry is more oriented toward investment goods, which tend to lag activity in other sectors.

Current account imbalances also suggest the rally in the euro/U.S. dollar may be overdone. The United States continues to post a very large balance of payments deficit, which has only been helped by ongoing central bank purchases of U.S. Treasury bonds. On the European side, a balanced current account and portfolio inflows are supportive of its currency. Looking specifically at the bilateral balance of payments between the two regions, net Eurozone inflows dominate. In the broader context of external imbalances, it is also worth highlighting the U.S. policy target of doubling exports within five years. Goldman Sachs estimates this would require the real trade-weighted dollar to weaken by about 30%. These factors all suggest the need for U.S. dollar devaluation.

There are scenarios in which this forecast could go wrong. The first involves European growth decelerating to a greater extent than expected. Another involves political uncertainty and the chance that support wanes for the support packages due to the result of regional elections across core Europe. On balance, however, the stabilization measures should reduce the risk of sovereign default in Europe, and thus lower risk premia, which will be positive for the currency. ■

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