Global Perspective from the Investment Advisory Group

The euro is close to parity

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Eylem Senyuz
Senior Global Macro Strategist
Portfolio & Market Strategy

Executive summary

The world has significantly changed since the Russian invasion of Ukraine, most visibly in Europe. In this new world, the U.S. dollar has become a safe-haven currency once again, and energy, priced in U.S. dollars, has become increasingly more expensive when purchased using European currencies. The global economic slowdown, essentially emanating from Europe, has highlighted the region's vulnerabilities, and rising sovereign rates have increased borrowing costs for companies. Undoubtedly, this confluence of factors has led to a lower euro. The euro is cheap for good reasons, and since we see no clear path for the end of Russian hostilities, the euro could become even cheaper than current levels, especially during the upcoming winter months.

What happened

The euro is close to parity ($1 = €1), the weakest level since the early 2000's, as many market participants assume that the European Central Bank (ECB) will choose a more gradual path to hike rates than the Federal Reserve's (Fed) expected path under the current inflationary environment. The ECB's data-dependent and flexible monetary policy approach is understandable as the region is flirting with strong recessionary headwinds. The ECB regrettably accepts that inflation will remain unacceptably high since monetary policy cannot control energy availability to the region, especially from Russia.

Since the Russian invasion of Ukraine, it is evident that a significant slowdown in Europe is unavoidable. Europe, which is mostly made up of countries deficient in energy and industrial materials, like Germany or the Netherlands, has new bottlenecks for already-constrained European production lines. In the current investment environment, global capital is attracted to stronger economies that can handle higher rates. Relatively speaking, the U.S. continues to have a more robust economy relative to its European peers, which has led to the faltering of the euro as it catches up to the reality of a worsening economy.

Even before the invasion of Ukraine and the pandemic, the Eurozone was stuck with lower potential economic growth—owing to an aging population, lower productivity, and an archaic bureaucracy. Japan has been in the same predicament for almost three decades now, and gradual debasement of the currency to gain a competitive advantage has been a policy of choice. Going forward, the Eurozone economies will be pressed to copy the same Japanese currency playbook.

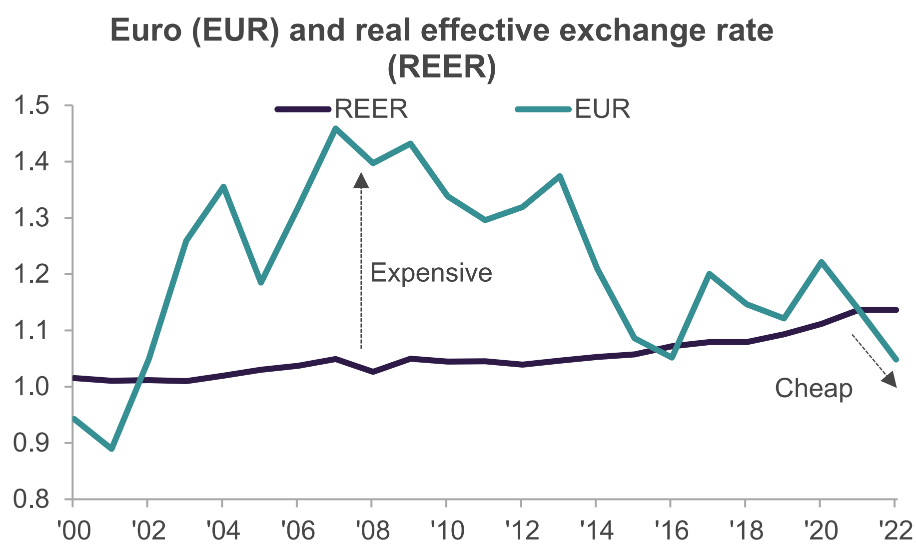
Our take

Euro is cheap for good reasons, and it could get cheaper

The real effective exchange rate (REER), albeit not perfect, is one of our favorite benchmarking tools to check the value of the currency against the U.S. dollar. This measure tracks the inflation differences between currencies and assumes that high inflation currencies will depreciate to keep their values stable relative to low inflation currencies. This measure for the euro, with a start date of the beginning of the new millennia, shows the euro is relatively cheap compared to the U.S. dollar.

During the boom years of 2002 to 2008, the euro generally stayed overvalued against the U.S. dollar as the result of a strong global economy where demand for European goods outpaced supply. The global financial crisis along with the European sovereign debt crisis in 2011-2012 changed that dynamic, and by 2015-2016, the euro had weakened to fair value. Divergent monetary policies between the ECB and Fed, like it is today, also played a major role in Euro's drop in value.

The pandemic and the subsequent Russian invasion of Ukraine have negatively impacted Europe's economic outlook even further, leading to a deeper drop in the value of the euro. We are almost half a year into the Ukrainian conflict with no clear path to sustainable peace. Assuming the current situation continues for a few years, Europe will struggle to locate sources of supplies for energy and industrial metals, leading to further weakness in the currency.



Data source: Truist IAG, Bloomberg

Europe's energy crisis is set to worsen in the upcoming winter

While European leaders are feverishly looking for fresh supplies, even relatively small supply disruptions could sharply exacerbate the situation. Last month, there was news that a U.S. liquefied natural gas terminal—which could potentially export U.S. natural gas to Europe—would be shut down until late 2022 due to a fire. This was unfortunate for European customers, and European natural gas prices have gone up nearly 80% over the last month. Plus, in July, a Norwegian energy company, supplying energy to the European markets, announced that offshore oilfield workers would go on strike, limiting supply. These types of typically one-off events now fuel extreme volatility in European energy prices.

Additionally, since energy is priced in U.S. dollars, this creates a negative feedback loop for Eurozone inflation. High energy prices become even higher when priced in euros, and that in turn results in higher inflation in the Eurozone. Higher inflation in the Eurozone increases the attractiveness of the U.S. dollar relative to the euro, so the euro goes down, and energy priced in euros goes even higher.

The ECB is already in crisis mode

Based on the latest proactive approach of the ECB, the last thing the ECB would like to repeat is another existential euro crisis like what happened during the 2015-16 period. Recent higher inflation has led to higher rates, and higher rates have started to pressure vulnerable economies in Europe, such as Greece and Italy. The ECB has already announced plans to reinvest maturing principal payments and coupons in a way that avoids dislocation in bond markets. This is a helpful acknowledgment that reduces financing risks in the Eurozone's peripheral economies. Nevertheless, it clearly shows where the fault lines are and forces the ECB to react forcefully. Like the 2015-16 period, the euro could lose further value if peripheral economies cannot handle higher rates and if the ECB fails to calm the market's fears.

Bottom line

Russia's aggression in Ukraine dislocated millions from their homes, caused unimaginable destruction to Ukrainian infrastructure, and, more importantly, countless Ukrainians lost their loved ones. We are almost half a year into the invasion, and the economic cost of the crisis to the surrounding region and the global economy is becoming much more visible. As we mentioned in our earlier research notes, European economies are the most vulnerable as they are closest to the epicenter of Russia's aggression.

Russia becoming a pariah state in the middle of Europe will complicate the potential growth outlook for Europe for many years to come. One way to cope with the negative effects is to maintain a relatively cheaper currency for the Eurozone economies. And, that is what is getting priced into markets currently. By historical standards, the euro is cheap versus the U.S. dollar, but it could get even cheaper since the search for alternative sources of energy could come at a higher cost. Thus, we continue to recommend an underweight position in overseas equities, especially in Europe.

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