THE EURO: HOW LOW CAN IT GO?

Jeremy Schwartz — Global Head of Research
03/03/2015

Recently, Professor Jeremy Siegel and I sat down with Brown Brothers Harriman currency strategist Marc Chandler. Given the European Central Bank's (ECB) recent activities, most of the discussion centered around the euro. **What's the Point of Quantitative Easing (QE)?** Because interest rates are already so low in much of the eurozone (can you believe Italian and Spanish 10- year bond yields are lower than U.S. 10- year bond yields, when in 2012, during the euro debt crisis, they were 400–500 basis points higher?), Professor Siegel believes the major effect of the ECB's QE is on the value of the euro. So much so that he's now looking to vacation in Greece next year instead of the Caribbean—illustrating how the lower euro can provide a boost to tourism that many of these countries need. **Why Did Germany Agree to QE?** Professor Siegel believes Germany went along with the QE because ECB president Mario Draghi could point to the relative success of the United States after its QE program. The U.S. created 3 million net new jobs last year and has the strongest economy in the developed world. The eurozone created no new jobs over last three years.[Source: Bloomberg] Draghi and former Federal Reserve (Fed) chairman Ben Bernanke (as well as Professor Siegel) were trained at MIT, and part of their economic training included the necessity for a central bank to be active and take aggressive steps when economic performance is disappointing. **Are We in a Currency War?** Chandler doesn't think so. Ukraine, Russia and Venezuela have had some of the weakest currencies in the world, and they are not winning this supposed currency war. Chandler discussed Italian prime minister Matteo Renzi's dream: the euro to reach parity with the U.S. dollar. The euro has already come down a great deal since Draghi said, "the rising euro is creating deflationary tendencies," back in April 2014, but it looks like this latest move in the euro may be just getting under way. **New Target: Euro at 85 Cents** Chandler thinks in the second half of 2016 we could see the euro drop from $1.13 to 85¢ versus the U.S. dollar. Of course, he cites the widening divergence between central banks—the Fed and the ECB is not going to last weeks or months, but a couple of years. Earlier this month, the ECB announced a commitment to continue these actions until at least September 2016. It seems the ECB is easing while the Fed is about to start tightening —even if we are still waiting to find out when the first tightening will take place. *(Note, I have been known to be a U.S. dollar bull—but there are not many who are claiming 85 cents on the euro.)* Chandler said that on a broad, trade-weighted index measured after inflation, the U.S. dollar currently is up only 12% from its lows set in 2011. He thinks when this cycle is over, there will be a 25%–30% increase in the dollar's value. From this perspective, the U.S. dollar cycle would just be getting started and may be less than halfway there. **Rising Dollar Creates Tightening for the Fed** I have been discussing how the rising dollar would take some of the heavy lifting away from the Fed in its tightening monetary policy and that we may not see such aggressive hikes this year from the Fed. Chandler has a back-of-the-envelope model that says the moves we've seen in the dollar so far correspond to a tightening of policy by 40 basis points. So while there is a divergence between central banks, the dollar is doing some of the Fed's tightening for it.

Important Risks Related to this Article

Foreside Fund Services, LLC, is not affiliated with Brown Brothers Harriman. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

For more investing insights, check out our Economic & Market Outlook

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Basis point : 1/100th of 1 percent.

Parity : Euro at parity means the euro would be trading at rate of $1 equals €1.

Deflation : The opposite of inflation, characterized by falling price levels.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Bullish : a position that benefits when asset prices rise.

Inflation : Characterized by rising price levels.