

How Low Can the Euro Go?

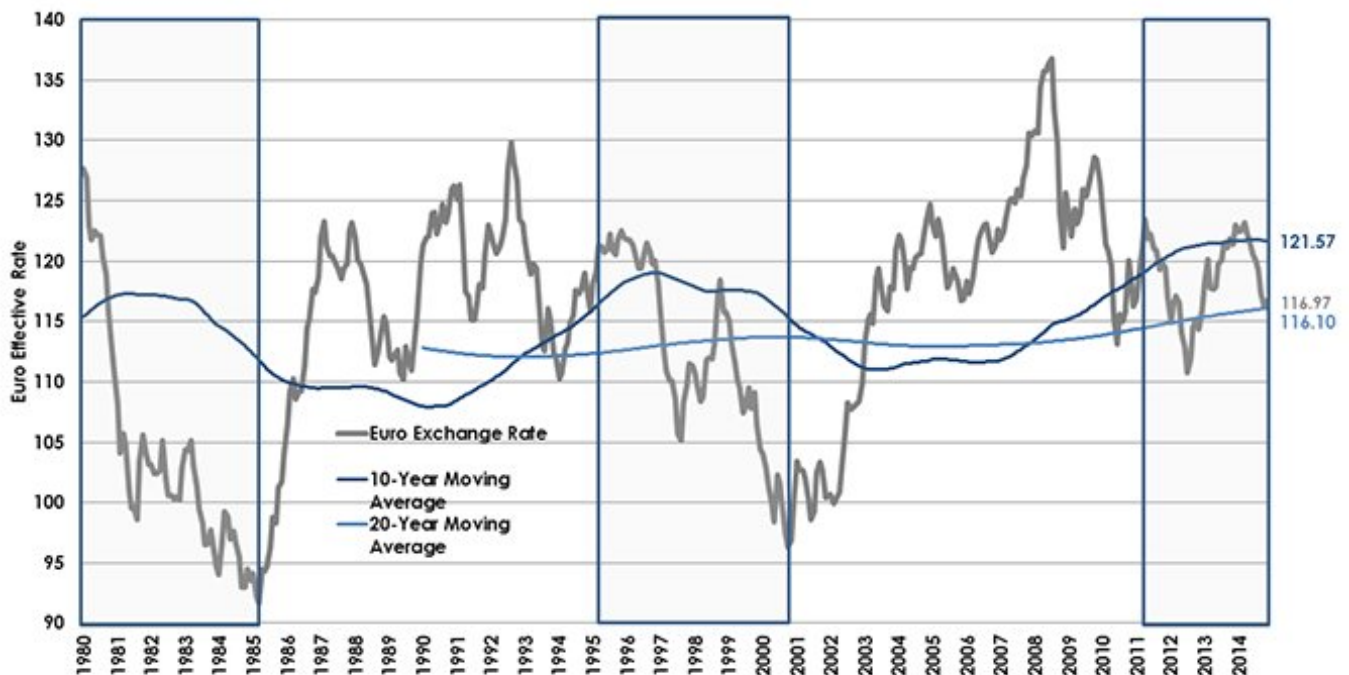
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In perhaps the biggest story of 2014, broad-based dollar strength had a significant impact on global markets. From stocks and bonds to commodities and inflation forecasts, very few markets were able to ignore the impact of a stronger U.S. dollar. Among the majors, the euro had its worst year against the dollar since 2005.¹ Yet in spite of a 12% slide in the euro last year, many analysts continue to view a majority of European economies as uncompetitive. A weaker currency could do much to improve this perception by helping to boost growth through cheaper exports. At the next meeting of the European Central Bank (ECB) on January 22, markets expect the formal announcement of an aggressive quantitative easing (QE) program. In anticipation, interest rates in most markets in Europe have continued to fall. In advance of the meeting, investors are also trying to understand what impact this might have on the value of the euro. On August 29, 2014, Goldman Sachs strategists made an ambitious announcement that called for euro parity against the U.S. dollar by the end of 2017.² Recently, they accelerated the timing of their euro parity call, predicting it will occur by the end of 2016 and will fall to 0.90 by the end of 2017.³ The update to their thesis was primarily driven by the ECB's pledge to meaningfully expand its balance sheet via QE. Should this forecast ultimately prove correct, the drop against the dollar would result in a decline of 17% from the current level. In our view, this call may not be as outlandish as it seems at first blush. As we have stated previously, the strength in the U.S. dollar and, conversely, weakness in the euro may just be getting started. As we show below, our key finding is that the euro is by no means undervalued at current levels. In a [recent blog post](#), we noted that the U.S. dollar was only slightly stronger than historical long-term averages using real effective exchange rates. Compared to nominal exchange rates, real rates provide a more appropriate estimate of the impact exchange rates have on an economy, economists have shown. The chart below updates this analysis using the euro.

Putting Euro Weakness in Context J.P. Morgan Real Broad Effective Exchange Rate Euro, 12/31/79-12/31/14



Sources: J.P. Morgan, WisdomTree, as of 12/31/14. Highlighted sections represent periods of secular appreciation in the U.S. dollar. Euro exchange rate estimates prior to the formation of the euro calculated from individual eurozone member currency weights.

Past performance is not indicative of future results.

As we stated earlier, this chart suggests that the euro is by no means “cheap” against its major trading partners, despite its sharp move lower in 2014. In fact, the euro is trading right above its 20-year average. With currency valuation in the middle of a longer-term range, we believe that bold action by the ECB can continue the weakening trend in the euro. With U.S. short-term rates poised to rise in 2015, the pendulum of monetary policy divergence could continue to support the dollar against a variety of foreign currencies, including the euro. We believe that, as a result of ECB action, a weaker euro can help stimulate economic growth, overcome deflationary pressures and ultimately improve the lingering debt sustainability issues plaguing peripheral European countries. In advance of these potential outcomes, we continue to advocate that investors hedge currency risk in their international portfolios via currency-hedged equity strategies or bullish U.S. dollar strategies.

1Source: Bloomberg, as of 12/31/14.

2EUR/USD was trading near 1.313 as of 8/29/14.

3Source: Goldman Sachs, as of 1/9/15.

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