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Economic Research:

Euro Weakness Is Not Over Yet

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Key Takeaways

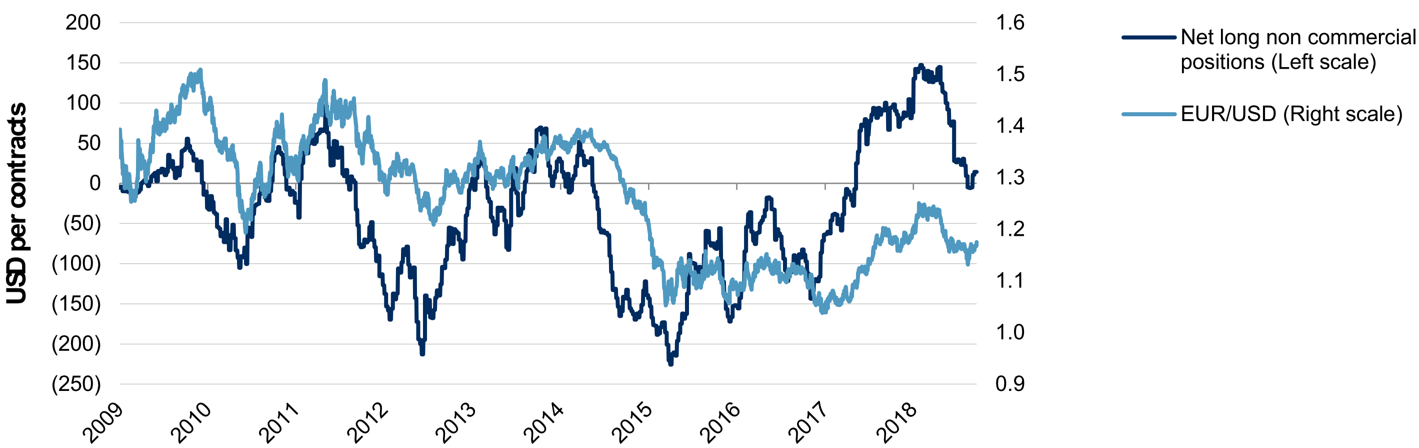
- We expect the euro to stay weak against the U.S. dollar into mid-2019.
- Diverging monetary policy between the U.S. Federal Reserve and the ECB, as well as political uncertainties in Europe, such as the Brexit negotiations, are the main factors weighing on the currency.
- Another factor is disappointing eurozone growth this year relative to the U.S, which has led us to lower our GDP forecast to 2% growth in 2018 and 1.7% in 2019 (from 2.1% and 1.7% in our June forecast).
- As monetary policy tightening by the ECB starts in third-quarter 2019, the focus will shift back to long-term macroeconomic fundamentals, such as purchasing power parity conditions and the eurozone's current account surplus, which should support a recovery of the euro's value against the dollar toward the end of next year.

After a strong start to the year, the euro was back at $1.13 this summer, its lowest level since mid-2017. A relatively weaker eurozone economy, faster U.S. Federal Reserve tightening, and political uncertainty has made euro assets relatively less attractive than their U.S. counterparts, shifting money away from the euro. The euro has now recovered slightly from its lows, trading at $1.18 at the time of writing. However, we think the dollar's strength is set to continue over the next three quarters.

While the unwinding of a high number of speculative (non-commercial) positions accelerated the euro's depreciation in the second quarter, these positions are now more balanced (see chart 1). This probably reflects a high level of perplexity among investors over the short-term direction of the biggest two world currencies. We therefore think macroeconomic fundamentals will play a stronger role in determining the trajectory of the exchange rate over the coming quarters. Although a rebound in growth could put some upward pressure on the euro, a continuous rise in monetary policy divergence and political risks such as Brexit negotiations and Italy's budget negotiations, are set to exert downward pressure on the currency at least until mid-2019. As a result, we do not see much potential for the euro to appreciate over the next three quarters. From the third quarter of 2019, the start of the European Central Bank (ECB) hiking cycle and what we expect to be a period of less heavy political risk should support an appreciation of the euro against the dollar, especially given that the euro looks undervalued compared to the eurozone's strong current account surplus or purchasing power parity exchange rate.

Chart 1

Speculative Positions Are Now More Balanced, Putting Less Downward Pressure On The Euro



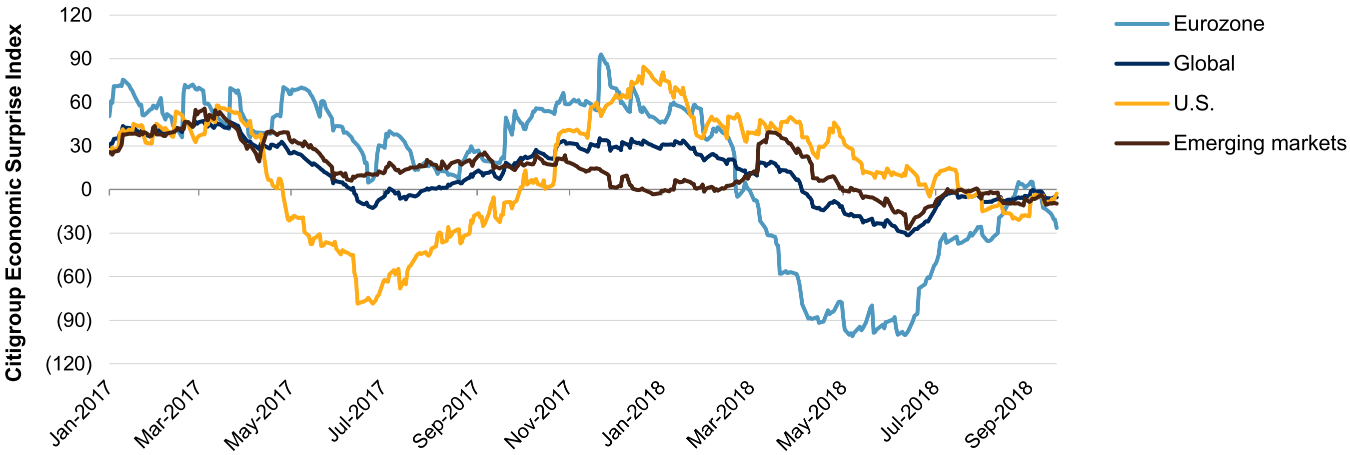
Sources: Datastream, S&P Global Ratings.

Economic Expansion Has Shifted To A Lower Gear

A disappointing growth performance relative to the U.S. since the start of the year is one major factor that has brought the euro-dollar exchange rate back to its mid-2017 levels (see chart 2). While our growth forecasts in March foresaw the eurozone growing by 2.3% this year and 1.9% next (see "The Eurozone Has Reached Cruising Altitude," published March 28, 2018, on RatingsDirect), we now project only 2% expansion for 2018 and 1.7% in 2019. Domestic fundamentals remain strong, owing to the ongoing strength of the labor market. However, the eurozone's industry has started to suffer from weaker external demand and rising uncertainties over the shape of trade relations. Weaker foreign orders, especially in the car industry--which additionally slowed to adjust to new emission standards--suggest last year's stellar export performance will not be repeated this year (see chart 3). What's more, emerging markets, which have been a key driver of the world trade recovery, are now set for a slowdown after a period of stress since the period of dollar strength.

Chart 2

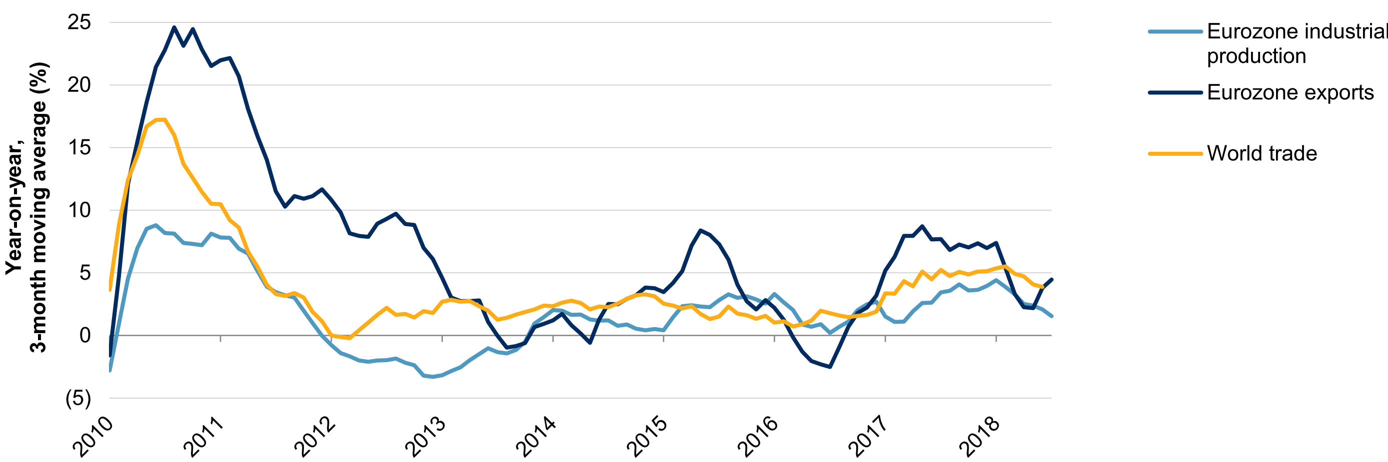
Eurozone Economic Activity Indicators Have Stopped Disappointing



Note: A positive (negative) number corresponds to better (worse) than expected economic activity data.
Sources: Bloomberg, Citigroup, S&P Global Ratings.

Chart 3

Weaker External Demand Has Started To Weigh On The Eurozone's Industrial Activity



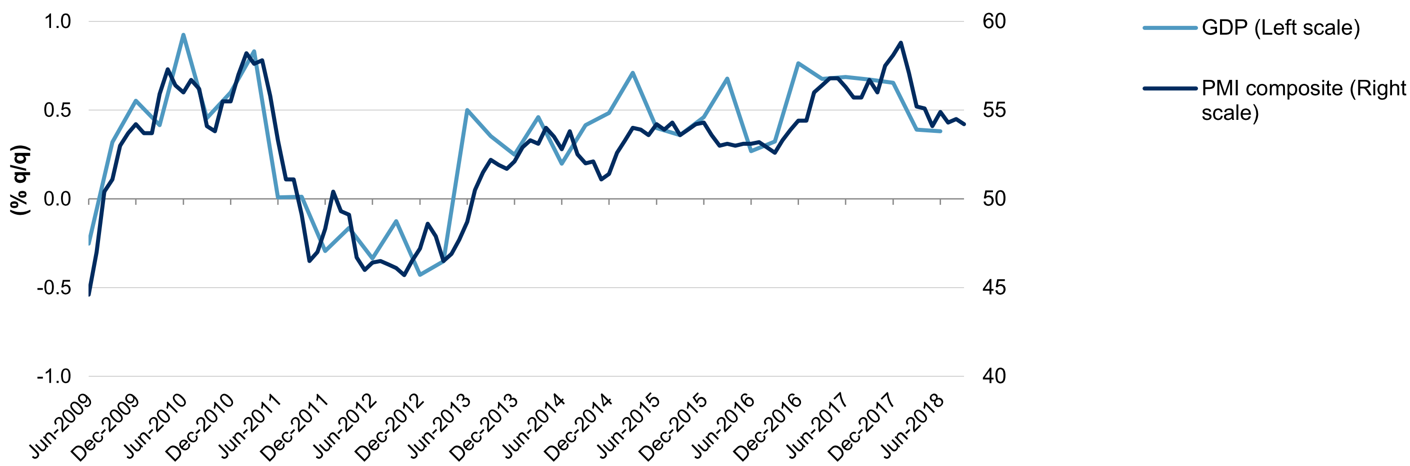
Sources: Datastream, S&P Global Ratings.

But The Second Half Of This Year Could Deliver Upside Surprises

Nonetheless, eurozone indicators are no longer disappointing. Survey data is no longer falling, pointing to a stabilization of economic growth at around 0.4% per quarter over the next few years (see chart 4). Even if growth in the U.S. remains strong, owing to the fiscal stimulus, the eurozone could deliver some upside surprises in the short term. We expect a small rebound in growth in the second half, and wage increases should start translating into inflationary pressures. This could put some upward pressure on the euro against the dollar in the short term.

Chart 4

Survey Data Now Points To A Stabilization Of Growth Around 0.4% Per Quarter



Sources: IHS Markit, S&P Global Ratings.

Monetary Policy Will Keep Diverging Until The ECB's First Rate Hike In Third-Quarter 2019

Despite some potential for upside surprises in terms of growth in the latter half of this year, the continued divergence in monetary policy is likely to be a stronger drag on the European single currency until mid-2019. With the Fed increasing the pace of its rate hikes since the middle of last year, and the ECB rates remaining at a standstill, short-term rates between the U.S. and the eurozone have diverged more quickly, contributing to this year's euro depreciation. The markets--like us--do not expect the ECB to raise rates before the third quarter of next year and envisage that the Fed will raise rates twice more this year. However, while the markets have only penciled in two more Fed rate hikes for 2019--less than the median of the dot plots (Fed members' predictions) suggest, in our assessment, the Fed is likely to hike three times next year. What's more, considering that the Fed followed the dots this year, market participants might potentially scale up their expectations.

By contrast, the European and U.S. central banks' monetary policy stance will likely start to converge again from 2020. By then, the ECB will only be at the start of its normalization path.

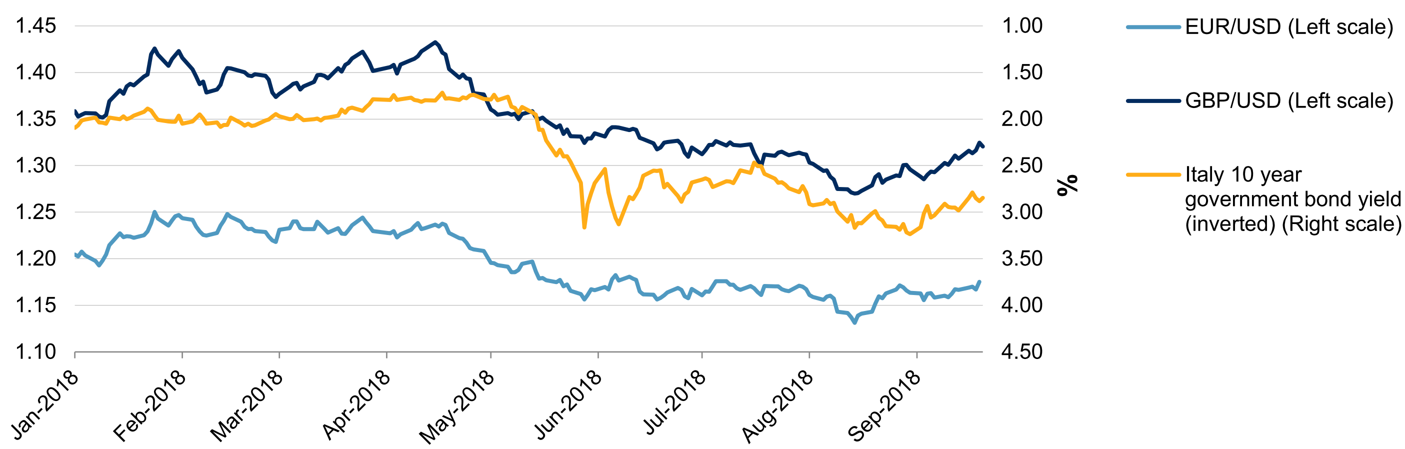
Looking at estimates of the equilibrium rate, we see the ECB raising rates twice in 2020 and in 2021. Meanwhile, the Fed is set to stop raising rates, as the positive effects of the fiscal package start to fade and the economy settles to its potential growth rate. Higher rates of returns of euro assets will increase their relative attractiveness, putting upward pressure on the euro.

Policy Uncertainty Will Play In Favor Of The Dollar Until Early 2019

Political uncertainty is now a bit less acute than over the summer, when the emerging market turmoil and uncertainty over Italy's new government trajectory drew investors to safe-haven currencies like the Swiss franc or U.S. dollar (see chart 5). That said, key questions, such as the shape of international trade, the outcome of Brexit, and Italy's budget will continue to hold the markets' attention until they appear to be resolved. This is unlikely to be before the beginning of 2019 in the case of Brexit. What's more, EU parliamentary elections in May 2019 could add another layer of uncertainty if eurosceptic parties perform well. Against this backdrop of policy uncertainty, markets participants could take a negative view of the euro, limiting the potential for its appreciation over the next two to three quarters.

Chart 5

Policy Uncertainty Over The Italian Budget And Brexit Have Put Downward Pressure On The Euro This Summer



Sources: Bloomberg, S&P Global Ratings.

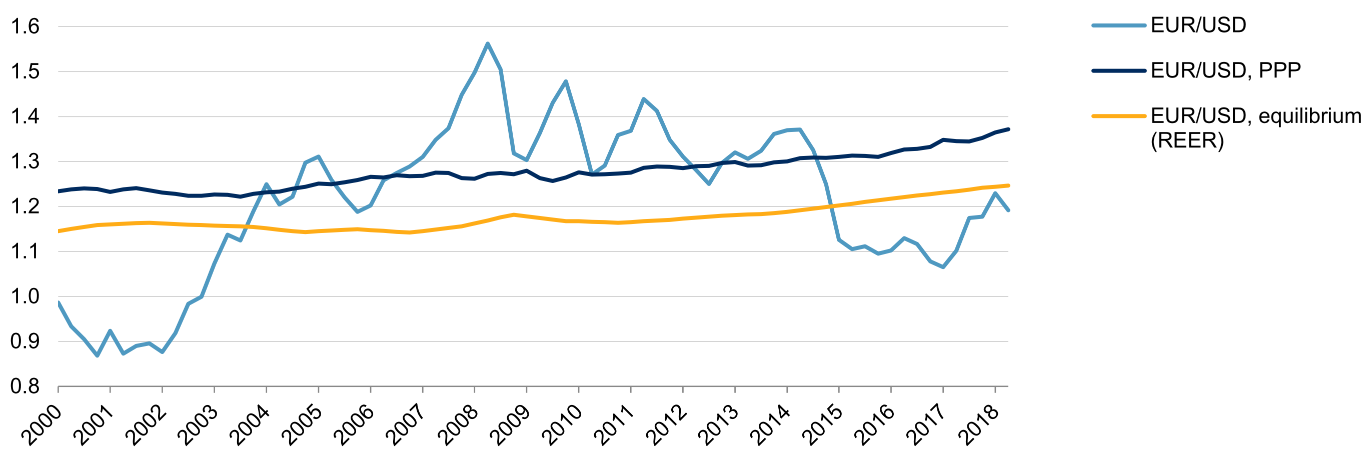
Added to this, the global trade war could also affect the dollar exchange rate. U.S. trading partners could be tempted to make use of the exchange rate to offset the tariffs they face on U.S. imports. This would lead to a further strengthening of the dollar in effective terms.

Long-Term Fundamentals Support Euro Appreciation Toward The End Of 2019

Although we expect the dollar's strength to persist over the short term, measures of currency misalignment suggest the euro-dollar exchange rate is undervalued. From the perspective of purchasing power conditions (PPP), for example, the euro looks 15% undervalued (see chart 6). Furthermore, a real effective exchange rate model looking at productivity differentials and net foreign asset positions suggests the euro is undervalued against the dollar by about 7%. We therefore expect the euro to appreciate as monetary policy divergence starts to diminish, the political context in Europe becomes clearer, and the focus shifts back to long-term dynamics in the second half of 2019. As such, the eurozone's move into current account surplus since 2012 would speak for a stronger currency, while the projected increase in the U.S. twin deficit, a result from the current fiscal package and the late cycle recovery, should put downward pressure on the dollar.

Chart 6

Models Of Currency Misalignment Suggest The Euro Is Undervalued Compared To Its Fundamentals

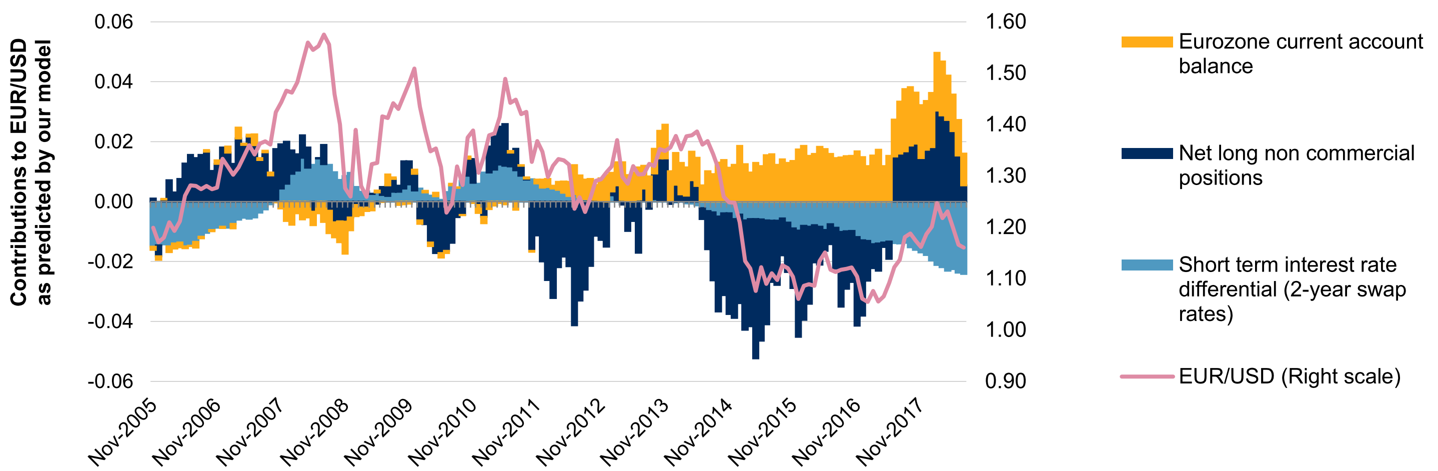


Sources: Oxford Economics, IMF, S&P Global Ratings.

To back up our reasoning, we also ran a model of the main drivers of the euro-dollar exchange rate (the interest rate differential, the eurozone current account balance, and net long non-commercial positions). Our results suggest that monetary policy divergence is the main factor weighing on the euro at this stage (see chart 7). The balance profile of non-commercial positions means it is currently not driving the exchange rate. Finally, the current account surplus is pushing the euro in the other direction, meaning that, as we don't see it diminishing much in our forecast, the reduction in monetary policy divergence should eventually lead to an appreciation of the euro.

Chart 7

Our Econometric Analysis Highlights Monetary Policy Divergence Is The Main Factor Weighing On The Euro



Note: Our model explains the Euro/USD with a constant, a lag, the short term interest rate differential, the Eurozone current account balance and net long non-commercial positions. Here we only show the contribution of the latter three.

Sources: Datastream, S&P Global

Table 1

Main European Economic Indicators September 2018

Central Forecast

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	United Kingdom	Switzerland
Real GDP (% change)									
2017	2.5	2.3	1.6	3.0	3.0	1.7	2.5	1.7	1.7
2018(f)	1.8	1.6	1.1	2.7	2.8	1.5	2.0	1.3	2.9
2019(f)	1.7	1.6	1.1	2.4	2.2	1.5	1.7	1.3	1.6
2020(f)	1.5	1.6	1.0	2.1	1.8	1.6	1.6	1.5	1.5
2021(f)	1.3	1.5	0.9	1.8	1.6	1.5	1.5	1.2	1.4
CPI inflation (%)									
2017	1.7	1.2	1.3	2.0	1.3	2.2	1.5	2.7	0.5
2018(f)	1.8	2.0	1.4	1.9	1.7	2.0	1.7	2.4	1.0
2019(f)	1.8	1.6	1.5	1.9	2.0	2.0	1.6	1.9	1.0
2020(f)	1.9	1.6	1.6	1.8	1.8	1.9	1.6	1.7	1.2
2021(f)	2.0	1.8	1.8	1.8	1.9	1.9	1.7	2.6	1.3
Unemployment rate (%)									
2017	3.8	9.4	11.3	17.2	4.9	7.1	9.1	4.4	3.2
2018(f)	3.3	9.1	10.9	15.5	3.9	6.0	8.3	4.1	2.9
2019(f)	3.0	8.8	10.6	14.3	3.8	5.8	7.8	4.3	2.7
2020(f)	2.8	8.7	10.5	13.3	3.7	5.7	7.5	4.5	2.7
2021(f)	2.6	8.6	10.5	12.5	3.6	5.6	7.2	4.6	2.6
10-year bond yield (yearly average)									
2017	0.4	0.8	2.1	1.6	0.5	0.7	1.1	1.2	-0.1
2018(f)	0.4	0.7	2.6	1.4	0.6	0.7	1.1	1.5	0.0
2019(f)	0.9	1.3	3.2	2.0	1.1	1.3	1.6	2.0	0.4
2020(f)	1.4	1.9	3.7	2.8	1.6	1.9	2.2	2.7	0.9
2021(f)	1.9	2.4	4.1	3.4	2.1	2.5	2.7	3.3	1.2
Central banks policy rates (yearly average)									
	ECB	**BOE**	**SNB**						
2017	0.00	0.29	-0.75						
2018(f)	0.00	0.60	-0.75						
2019(f)	0.08	0.84	-0.69						
2020(f)	0.50	1.31	-0.25						
2021(f)	1.00	1.59	0.25						

Table 1

Main European Economic Indicators September 2018 (cont.)

Exchange Rates

	USD/EUR	USD/GBP	EUR/GBP	CHF/USD	CHF/EUR
2017	1.13	1.29	1.14	0.98	1.11
2018(f)	1.19	1.34	1.13	0.97	1.15
2019(f)	1.20	1.35	1.13	0.96	1.15
2020(f)	1.26	1.46	1.16	0.92	1.16
2021(f)	1.25	1.47	1.17	0.92	1.15

This report does not constitute a rating action.