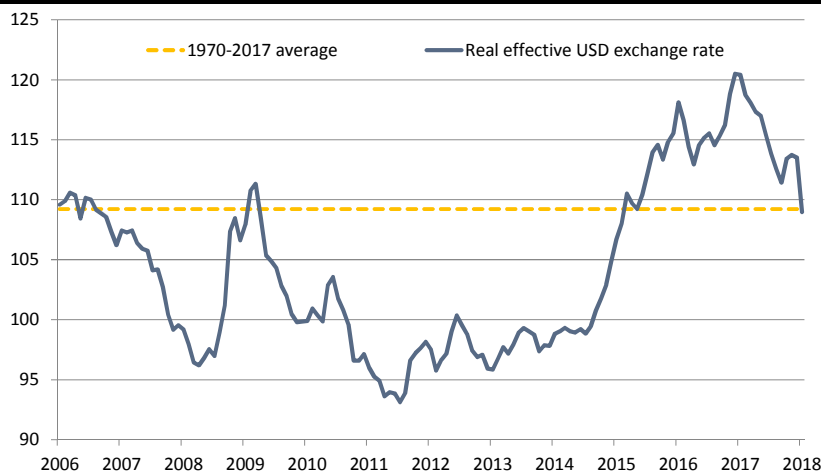


26 January 2018

Return to the mean: the currency story

Real effective exchange rate of the US dollar (2010 = 100)



Monthly data. Source: OECD, Berenberg calculations.

- The great US dollar correction:** Not for the first time, events have overtaken our forecasts. When the greenback seemed to be surging towards parity with the euro in late 2016, we swam against the flow, suggesting that the euro could rise modestly in 2017 and 2018 and approach USD1.25 by 2020. Instead, the euro reached USD1.25 on 25 January 2018 as the European Central Bank (ECB) chose to not react to US Treasury Secretary Steven Mnuchin's attempt to talk down the dollar with an equally stark verbal intervention of its own.
- Markets seem to be ignoring Congress and the Fed:** At first glance, the dollar weakness seems to defy macroeconomic logic. While the US Fed looks set to raise interest rate at least thrice by 25bp this year and may well deliver four such hikes, as we expect, the ECB will almost certainly keep rates at rock-bottom levels until early 2019. Moreover, whereas the US is granting itself a major fiscal stimulus this year, Eurozone governments are loosening their fiscal reins only very cautiously. Tight money, loose fiscal: on its own, the US policy mix would argue for a stronger greenback.
- Back to the mean:** To assess the recent moves, we need to look beyond just the policy mix. Even at current levels, the US dollar is not weak. In real trade-weighted terms, it is merely giving up its prior overvaluation and returning to its long-term average – see chart. Versus the euro, our best guess of long-term fair value in terms of purchasing power parity is USD1.25-1.30 per euro. This is not far from the more sophisticated OECD estimate for 2016 of USD1.33 and The Economist's down-to-earth "Big Mac" index with a USD1.34 estimate in its January 2018 update.
- The funding gap:** While the US is running a current account deficit of 2.5% of GDP in 2017, the Eurozone has a significant surplus. The US must offer more promising expected returns on investment including higher rates and yields to attract the funds to cover its external deficit.
- Risk on:** Unlike the euro, the US dollar counts as one of the ultimate safe havens in the world. In times of crises and widespread anxiety, money tends to flow into the US, while dollar-based investors dare not venture abroad. Hence the dollar strength during the crisis in many emerging markets in 2016. Since early 2017, investors have shifted ever more into risk-on mode. Encouraged by a largely synchronised global economic upswing in which many regions such as the Eurozone and Japan have sprung upside surprises, investors seem to re-directing funds out of the dollar into opportunities elsewhere that were deemed too risky before.
- Markets have their own logic:** In the search for a new equilibrium, they tend to overshoot. We now project a gradual further rise of the euro to USD1.28 by the end of 2019. The risk is that the euro may head higher faster than that, only to correct such an overshoot later on. As long as the stronger euro goes along with solid demand growth in the Eurozone's major export markets such as the US and China, it should not crimp the Eurozone upswing very much as the mostly high-end Eurozone exports sell more on quality than on price.

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