

VAKIFBANK GLOBAL ECONOMY WEEKLY

Upcoming Downturn in EUR/USD



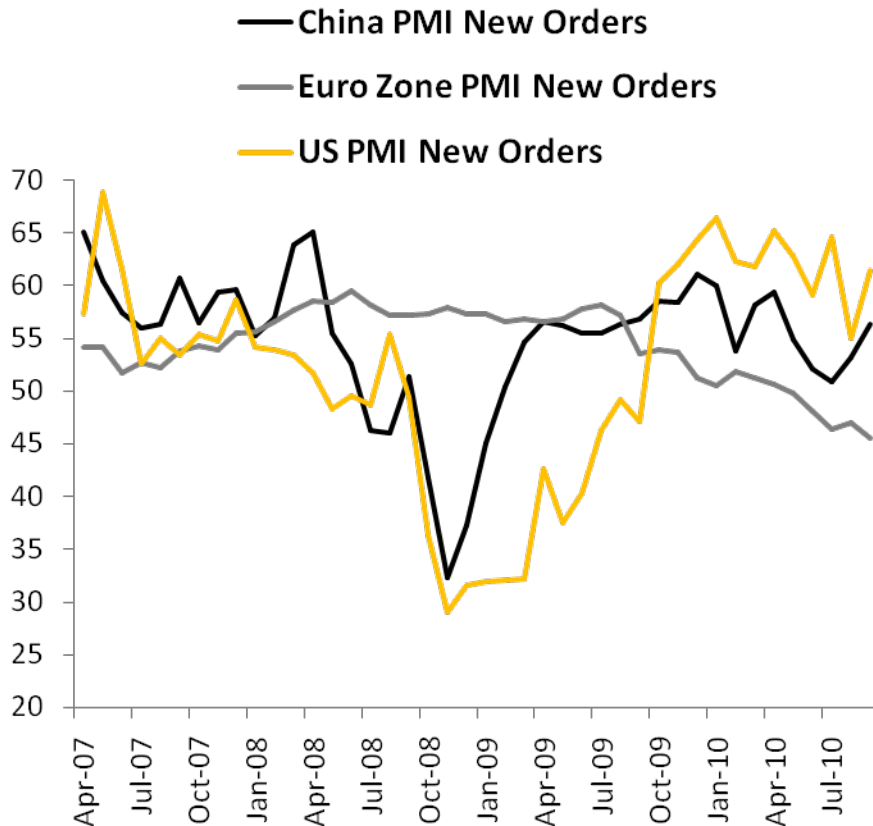
T. Vakıflar Bankası T.A.O



Factors supporting and limiting the upward movement in EUR/USD

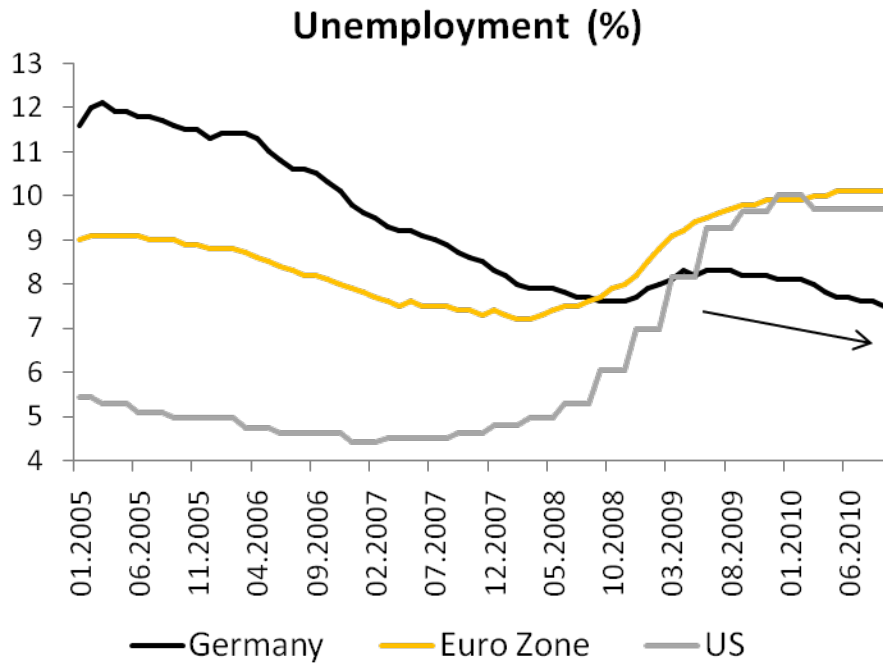
- ✎ The decreasing inflationary pressures and the slowdown in the recovery momentum, increased the expectations of further monetary easing (QE2) in the US economy in the last couple of weeks.
- ✎ Speculation on FED's easing triggered a depreciation in the USD and resulted in an upward movement on EUR/USD.
- ✎ In this study, we investigate and analyze the factors supporting and limiting the upward movement in EUR/USD.

Macro Economic Outlook of US and Euro Zone - I

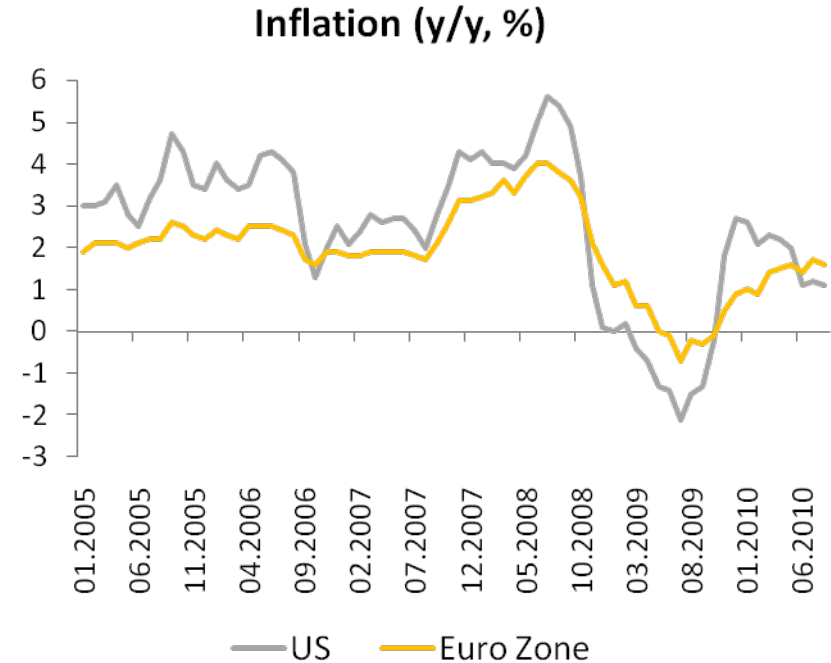


Source: Bloomberg


- US and Euro Zone (EZ) economies could not make a decent progress in the aftermath of the recession.
- Public finances have deteriorated due to the emergency measures taken against the slowdown in both economies.
- EZ countries have already started implementing fiscal stability measures while the scope for further fiscal measures are very limited in the US.
- Consequently the growth pace in the two regions is expected to be slow for an extended period.
- Nonetheless, the PMI new orders index indicates a slowdown in EZ and confirms a slightly brisk performance in the US as in China.
- This implies that the EZ does not have a strong hand in terms of sustained growth.



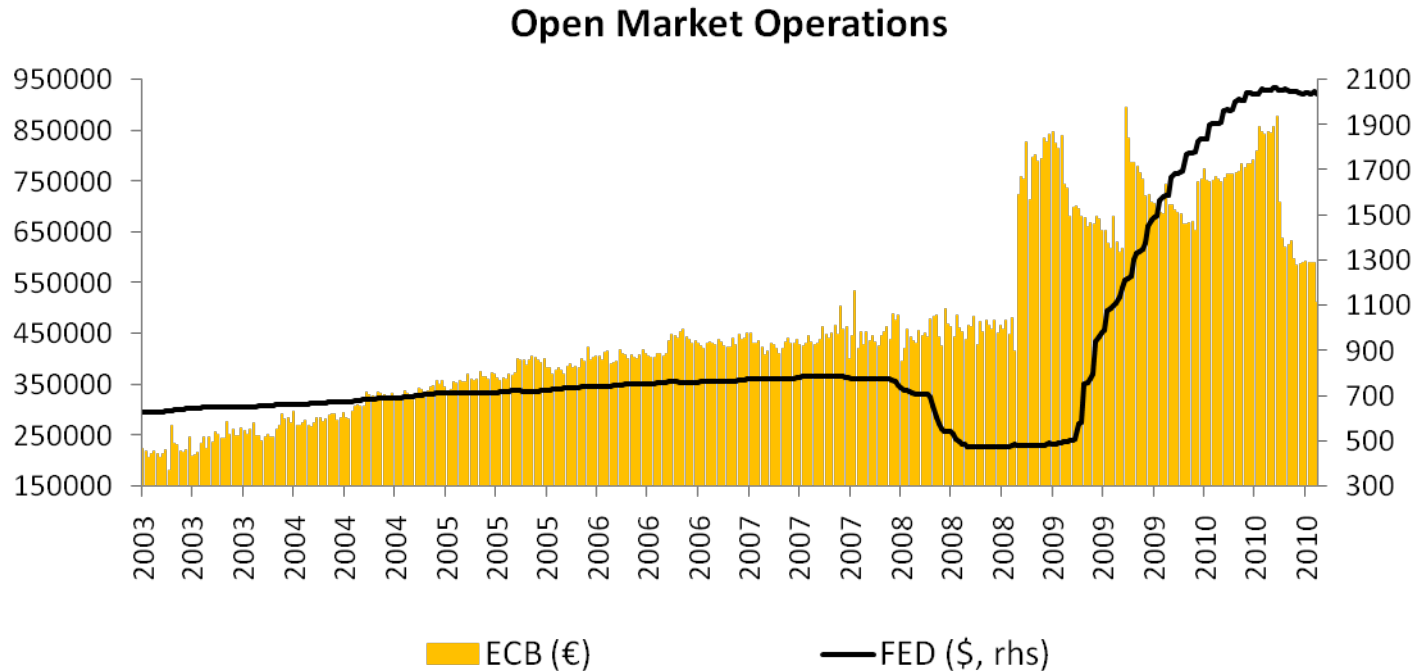
Source: Bloomberg



Source: Bloomberg

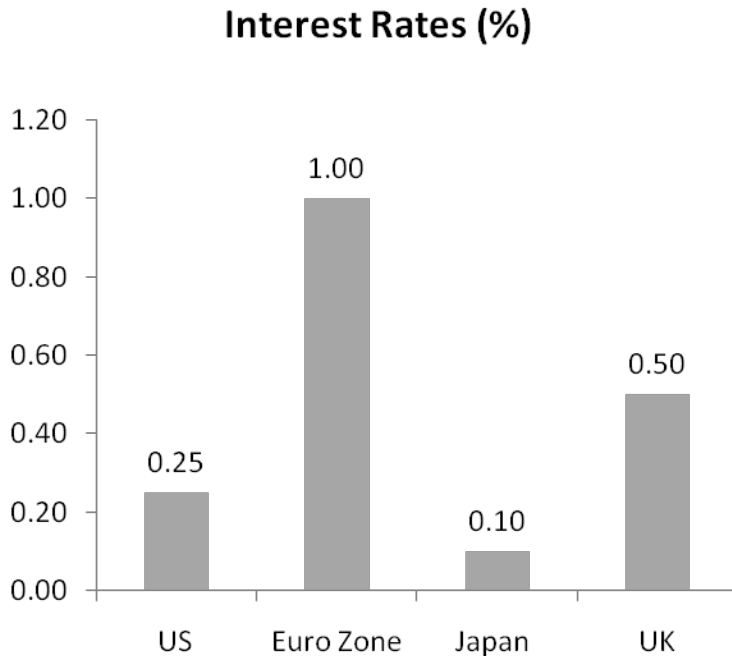
 In EZ, unemployment rate is higher than the US, but in Germany which is the biggest economy of the EU, it is lower than both regions and has been declining since February 2009. Besides, in contrast to US relatively high inflation rate in EZ supports the tightening monetary policy of European Central Bank (ECB).

Expectation of QE2 in US against tighter monetary stance of ECB - I



📌 The waning recovery signals enforces the FED to start the second pace of quantitative easing. Current amount of the open market operations of the FED is indicating that the exit strategy is out of question and FED's QE2 is on the way. However ECB is progressively decreasing its open market operations. Thus, decreasing EUR liquidity against increasing total USD amount in the market, supports the upward trend of EUR/USD.

Expectation of QE2 in US against tighter monetary stance of ECB - I

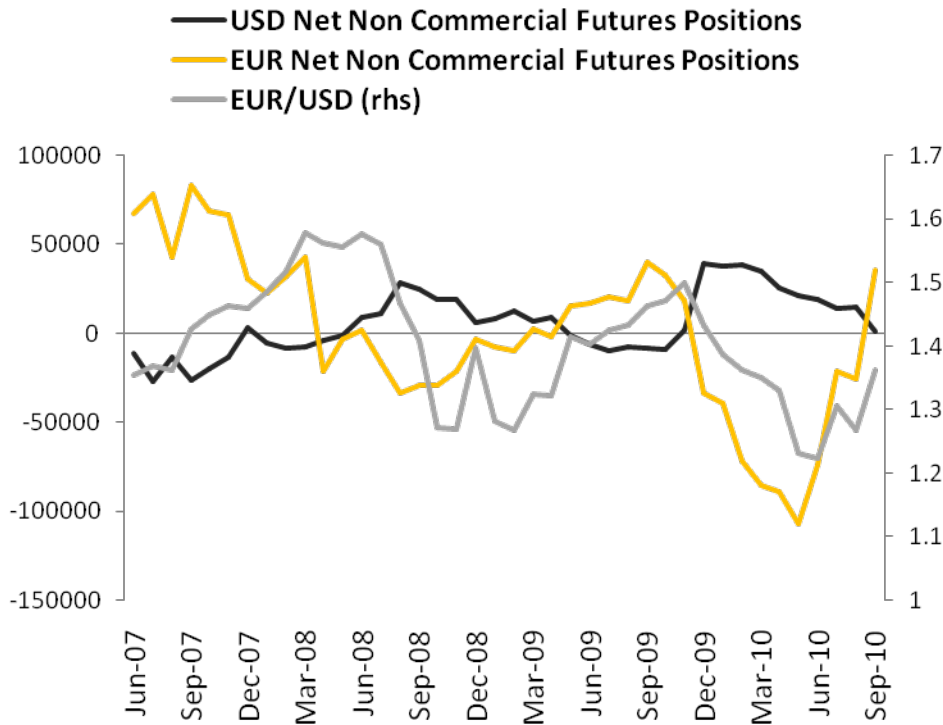


Source: Bloomberg

- FED considers the economic outlook in taking the policy decisions, while the priority of ECB is price stability. Due to the increase in inflation rate, ECB is expected to tighten monetary policy.
- Among advanced economy central banks ECB is the only central bank which keeps the interest rates high despite the European debt crisis.
- The interest rate differential between US and EZ is boosting the demand for euro.

Factors limiting upward movement in EUR/USD

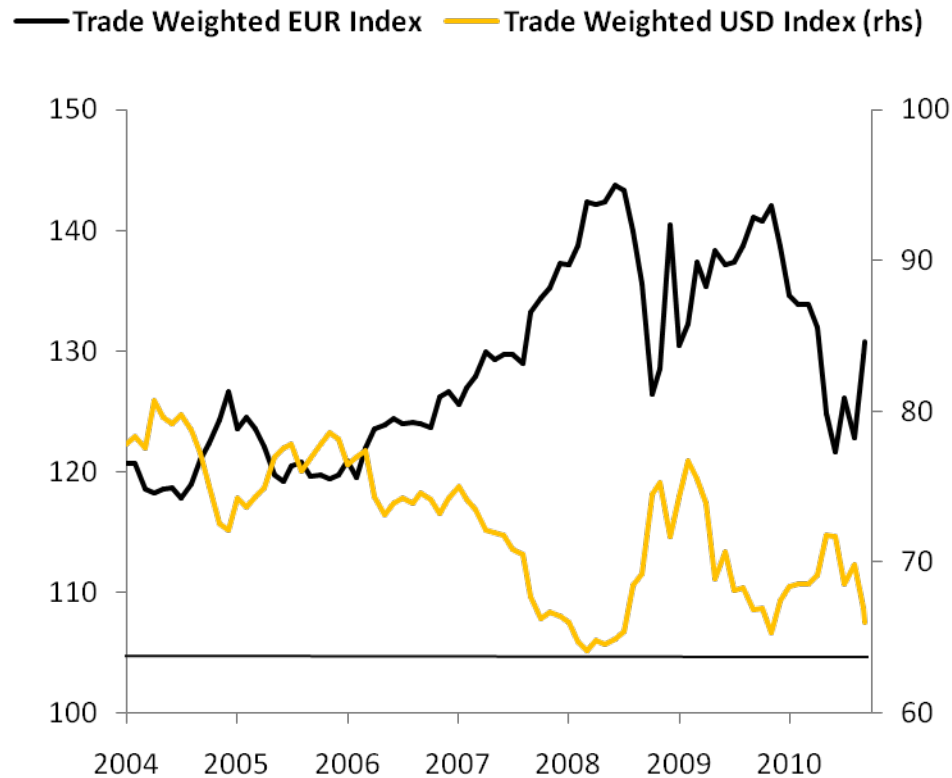
Central Bank Interventions and Investment Positions in USD and EUR



Source: CFTC, Bloomberg

- An increase in dollar liquidity as a result of BOJ FX interventions.
- Central Banks of EM economies (especially exporters such as China, Brazil and Russia) aim to prevent their currency appreciation.
- Decrease in USD non commercial futures long positions indicates depreciation in USD. However, it is obvious that long positions in USD is getting closer to its lowest level in 2009 and this may limit the upward movement in EUR/USD.

Trade Weighted USD and EUR Index

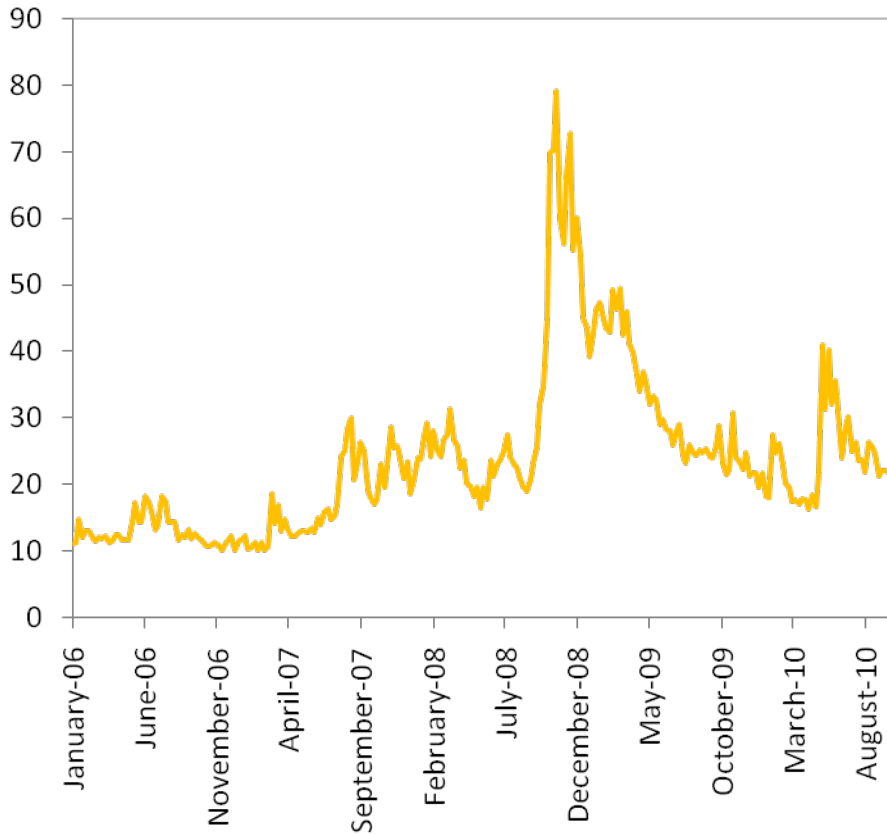


*Deutsche Bank Trade Weighted Index
Source: Bloomberg

- Trade weighted index (TWI) shows a weighted average of exchange rates of local and foreign currencies with the weight of countries' trade shares.
- TWI dollar index seems to reach its lowest level in 2008. However, it still has a way to go.
- TWI euro index is also below its highest level in 2008. Widening sovereign credit spreads in EZ countries causes concerns that EZ growth will not be sufficient to allow the fiscal consolidation plans to be credible. TWI euro index may turn below its highest level in 2008 with these concerns.

Global risk appetite is still weak

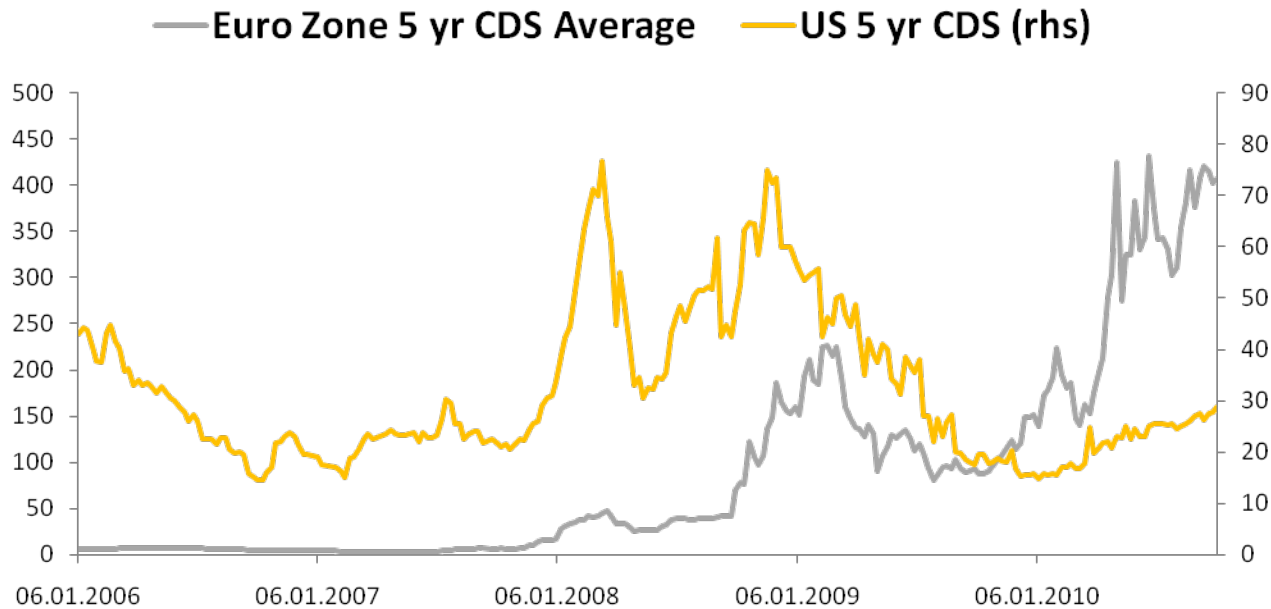
VIX Index



Source: Bloomberg

- Although risky assets have rallied off of their lowest levels, global risk appetite is still weaker than the pre-crisis period.
- The leading global PMI indexes show industrial production momentum is still slowing and this suppresses global risk appetite.
- If global risk appetite increases, portfolio flows out of the US into risky assets of emerging markets will also increase. And, this may cause further depreciation in dollar.

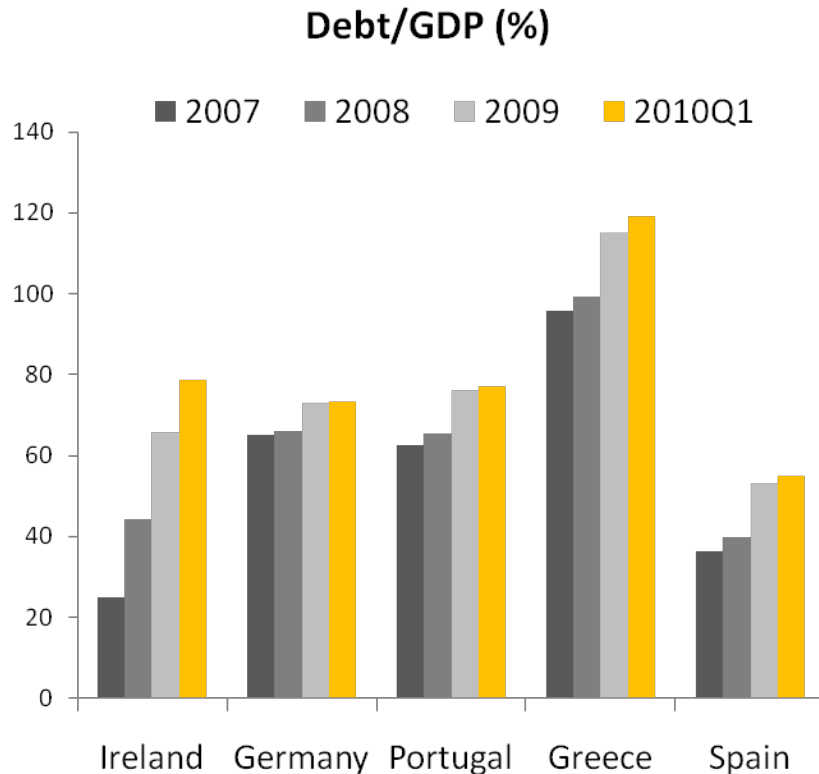
Vulnerabilities of Euro Zone Economy - I



Source: Bloomberg

- High sovereign risks in EZ are suppressing the upward trend in EUR/USD.
- The average of the 5 year CDS spreads of the most vulnerable economies (Greece, Ireland, Spain, Portugal, Italy) of EZ indicates the upward pressure on sovereign risks.
- There's a slight increase in the US sovereign spreads since January 2010, but they are relatively contained.

Vulnerabilities of Euro Zone Economy - II

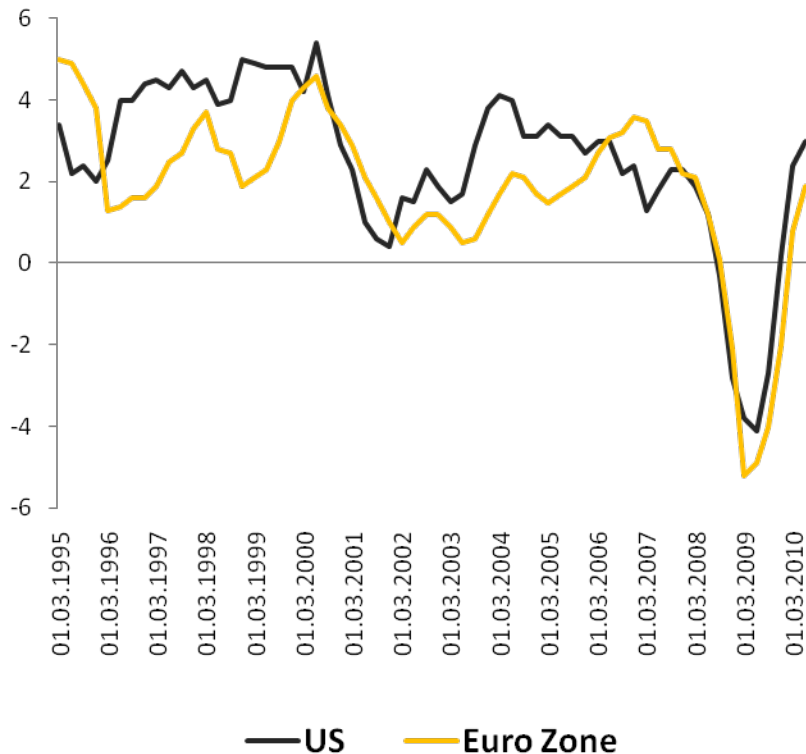


Source: Bloomberg

- ✎ The debt to GDP ratio of EZ is around 80% and it is still increasing in the weakest economies such as Greece and Ireland.
- ✎ The widening public deficits avoid being optimistic about EZ economic recovery.
- ✎ A possible increase in inflationary pressures might pave the way to contractionary monetary policy.
- ✎ This will dampen the ability of the governments to take immediate action in case of a further deterioration in the growth outlook under the contractionary fiscal policy constraints.

Vulnerabilities of Euro Zone Economy - III

GDP Growth Rate (yoy, %)



Source: Bloomberg

- There's a precise similarity between EZ and US growth trend.
- EZ growth performance is generally lagging US growth.
- This implies that in the case of a possible slowdown in the US in the forthcoming period, EZ growth will feel the similar effects.
- In this case, ECB's hand will be restricted in the contractionary monetary policy stance.
- The decreasing competitiveness of the EZ countries in foreign trade, which is not welcome by the governments, is another restrictive element on the upward movement in EUR/USD.

Downturn in EUR/USD might be close

- ✔ FED's expected QE2 policy in the face of ECB's tighter monetary policy is the main factor behind the upward trend in the EUR/USD.
- ✔ ECB is expected to increase the policy interest rate not earlier than 2011 Q3. But the economic vulnerability is a considerable drag for the tight monetary policy.
- ✔ The fiscal stability measures might have a delayed negative impact on the growth performance of EZ countries.
- ✔ The inflationary pressures besides the slow growth might complicate ECB policies.
- ✔ These factors restrict the potential of euro appreciation.
- ✔ The appreciation of euro in a weak external demand environment, enforces the EZ governments and ECB to be smarter on the currency front.
- ✔ FED's efforts to sustain growth momentum, might increase the confidence in USD.
- ✔ The fact that the risk appetite is still lower than the pre-crisis level, shows that the markets are prudent about global instabilities. This might trigger a downturn in EUR/USD.
- ✔ Trade Weighted USD and EUR indexes are also supporting this probability.

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