PORTFOLIO INSIGHTS

EUR/USD: Stuck in a rut?

January 2019

IN BRIEF

- For most of 2018, eurozone and US monetary policy appeared to be on a largely pre-set course. The European Central Bank (ECB) suggested that its quantitative easing programme was likely to cease at the end of 2018, with rate increases to follow in the late summer of 2019. The Federal Reserve was happy, meanwhile, to continue with gradual, once-per-quarter rate hikes.
- However, there is considerable uncertainty at the beginning of 2019. Following the dovish tone of January's Federal Open Market Committee (FOMC) meeting, the market is discounting a small probability of a rate cut by Federal Reserve towards the end of this year, although we expect the next move by the Federal Reserve to be a rate hike, while ECB president Mario Draghi has warned that the risks to the eurozone's growth outlook have shifted to the downside.
- Draghi's warning highlights the potential for future dovish changes to the ECB's monetary policy stance, which would be negative for the Euro and frustrate those calling for the EUR/USD rate to rise towards traditional measures of fair value in the first half of 2019 following January's change in FOMC rate guidance.

LONG-TERM VALUATION MEASURES AS A STARTING POINT

Traditional valuation metrics based on purchasing power parity suggest the euro is 10%-15% undervalued against the US dollar. The undervaluation appears far less pronounced when measured on a real effective exchange rate (REER) basis, but on both counts the euro does look below fair value.

The euro's undervaluation appears hard to explain at first glance, given the eurozone has run a persistent current account surplus in excess of 3% of GDP for the past five years. Although trending lower over the last 12 months, such a large surplus might have been expected to have placed upside appreciation pressure on the euro—and perhaps it did.

However, a closer look at the empirical evidence reveals the reasons for the euro's weakness. First, disappointing growth and inflation data combined with many political challenges have deterred capital flows into the eurozone. At the same time, the ECB has maintained negative interest rates, reinforcing the policy divergence with the Federal Reserve as US rates began to rise. Both these factors have worked to keep the euro on the cheaper side of traditional valuation metrics.

CONSENSUS FORECASTS SUGGEST THE EURO WILL STRENGTHEN IN 2019

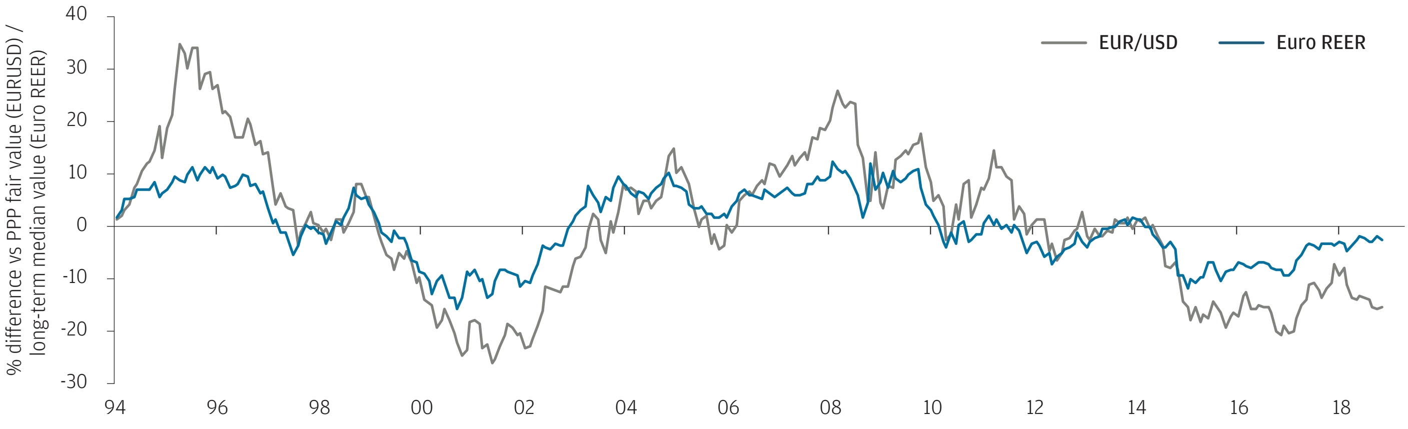
The market expects the euro to strengthen in 2019, with consensus forecasts suggesting an appreciation towards 1.20 vs. the US dollar. These consensus forecasts typically incorporate a weaker US growth outlook in the second half of 2019 as fiscal stimulus fades, a dovish FOMC outlook, and a growth rebound in the eurozone that allows the ECB to start normalising monetary policy. The consensus also typically incorporates some valuation-based upwards pressure on the EUR/USD rate, aided by the eurozone's relatively superior balance of payments position.

Recent growth developments suggest that the risks to this bullish consensus outlook are to the downside, at least over the next few months. While we are well aware that a number of temporary factors may be weighing on eurozone growth (for example, new emissions standards in the auto sector, political protests in France) it does also appear that the eurozone economy is being significantly impaired by a slowdown in global trade. Meanwhile, although we may have seen peak rates of US growth for this cycle, we still forecast an above trend rate of US economic growth over the balance of 2019 as a result of strong consumer and labour market fundamentals.

MONETARY POLICY OUTLOOK SHOULD KEEP EUR/USD RANGE BOUND

Whilst we acknowledge the FOMC has made a significant change in its forward guidance, including an earlier than previously expected end to balance sheet reduction, we believe current market pricing of easing by the FOMC this year is too pessimistic. Meanwhile, it is possible the market may need to incorporate a dovish shift in ECB monetary policy following the acknowledgement that Eurozone growth risks have now shifted to the downside. As a result, we believe relative interest rate differentials are now more likely the move in the US dollar's favour in the coming months – a shift that would keep the EUR/USD rate suppressed within the trading ranges observed over the latter stages of 2018 and early 2019.

EUR/USD VS EURO REER



Source: Bloomberg, J.P. Morgan Asset Management as of 31.12.2018.

Currency Management

Since our first segregated currency overlay mandate funded in 1989, J.P Morgan Currency Group has grown to manage a total of USD 361 billion in bespoke currency strategies. Our clients include governments, pension funds, insurance clients and fund providers. Based in London, the team consists of 20 people dedicated exclusively to currency management with an average of over 15 years of investment experience.

We offer a range of hedging solutions for managing currency risk as well as a tailored optimal hedge ratio analysis:

- Passive currency hedging serves to reduce the currency volatility from the underlying international assets. It is a simple, low cost solution designed to achieve the correct balance between minimising tracking error, effectively controlling transaction costs and efficiently managing cash flows.
- Dynamic 'intelligent' currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
- Active 'alpha' currency overlay strategy offers clients' passive currency hedging, if required, combined with an active investment process to deliver excess returns relative to the currency benchmark. Our approach is to build a global currency portfolio combining the output of fundamental models and incorporating the qualitative views of our strategy team.

LV-JPM51815 | 01/19 | 0903c02a82406934

J.P.Morgan
Asset Management