Assessing the outlook for EURUSD in a post-Covid world

July 2020

IN BRIEF

- In recent years the euro has traded persistently below most currency forecasters' estimates of long-term fair value vs. the US dollar.
- The decline in EURUSD from an average of 1.33 between 2010-2014 to an average of 1.13 in the years since reflect persistent growth underperformance in the eurozone, lingering uncertainty surrounding the sustainability of an incomplete monetary union and—up until very recently—monetary policy divergence between the Federal Reserve (Fed) and the European Central Bank (ECB).
- However, the Covid-19 shock has radically changed the macro landscape and there are now good reasons to expect appreciation of the euro vs. the US dollar in the coming quarters. As a result, euro-denominated investors are likely to experience FX-related losses on US dollar-based investments.
- We look at some of the potential options for investors, including undertaking bespoke hedge ratio studies to determine an appropriate hedging strategy at either a holistic or individual asset class level. We also look at how the effects of currency movements can be mitigated through either passive or more dynamic risk management techniques.

ESTIMATING EURUSD FAIR VALUE

The euro looks undervalued vs. the US dollar, although less than naïve estimates based on purchasing power parity (PPP) would imply.

A relative PPP-based estimate of fair value for EURUSD would place long-term fair value at around 1.30. The "magnetic pull" of long-term fair-value estimates has likely been the reason why the median estimate of the foreign exchange (FX) forecasting community has persistently and incorrectly forecasted EURUSD higher in recent years.

We remain sceptical that fair-value estimates of EURUSD are as high as the consensus expects, principally because we believe the structurally positive shock the shale oil and gas sector has had on the US balance of payments position has not been well understood and calibrated into forecasting analysis. Simply put, the US trade balance position in energy sectors has moved from a deficit of ~1.5% of GDP over most of the past two decades to a small energy trade surplus position over recent years.

We believe the change in the US energy trade balance has raised the equilibrium fair value of the US dollar by 5%-10% relative to its prior long-term equilibrium value. Nevertheless, the euro still trades below any reasonable estimate of long-term fair value vs. the US dollar.

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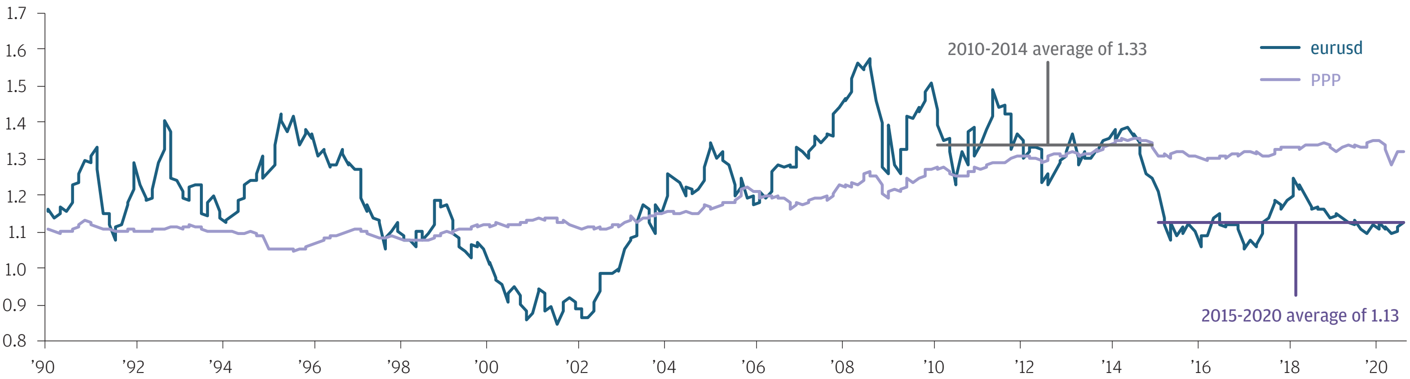
EXHIBIT 1: EURUSD AND EURUSD RELATIVE PPP



Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

CYCLICAL DEVELOPMENTS SUPPORT THE CASE FOR A RISE IN EURUSD

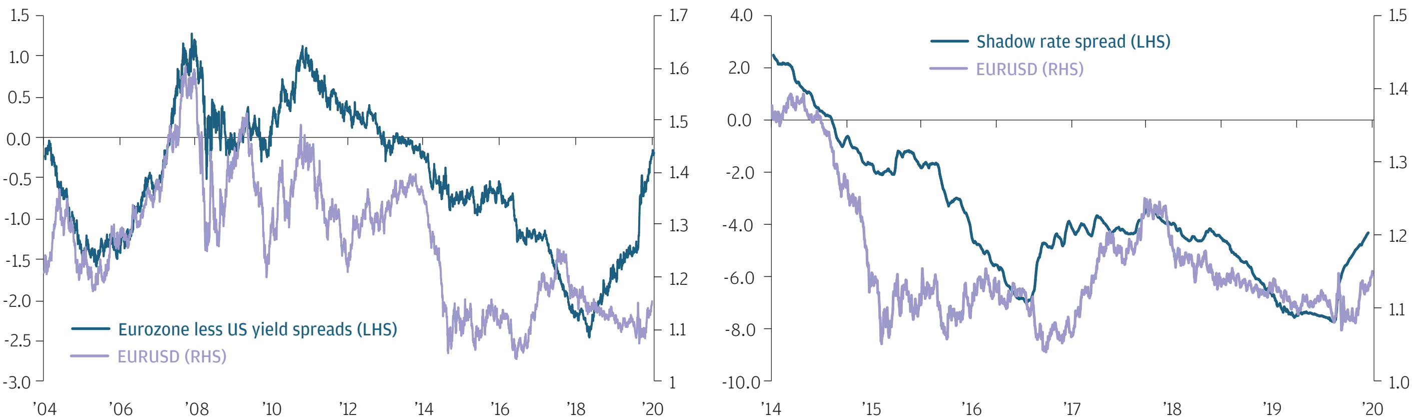
The severe global recession that resulted from the Covid-19 shock has caused significant changes in the monetary and fiscal landscape. Central banks have cut rates to the effective lower bound and in many cases have restarted quantitative easing (QE) programmes. Fiscal policy has also been loosened substantially.

In the US, the Fed moved rapidly to cut rates to zero and expanded its balance sheet at a rate that matched its response to the 2008 global financial crisis in a matter of weeks. As the ECB already considered interest rates close to the lower bound, its response focused on upscaling its asset purchases to ease monetary policy and to address funding pressures in eurozone countries with weaker fiscal positions (such as Italy). Both central banks are likely to continue to expand their balance sheets and keep interest rates at the effective lower bound for the foreseeable future.

The net result of these policies was a substantial narrowing of interest rate spreads between the US and the eurozone, which now appears to have strengthened the case for a rise in EURUSD. This spread narrowing can be viewed via traditional interest rate spread measures (**EXHIBIT 2**) or via J.P. Morgan Asset Management's measure of shadow rates, which calibrate the impact of changes of official policy rate spreads and the impact of unconventional policy easing on long-term forwards rates. The signal from interest rate markets is relatively clear: EURUSD should trend higher.

The signal provided by equity markets is less obvious. US equity markets have consistently outperformed European equivalents in recent years. Many analysts would now point to expensive valuations of US stock markets relative to Europe and the case for rotation into eurozone equities away from US equities.

EXHIBIT 2: EUROZONE AND US YIELD SPREADS, AND SHADOW RATE SPREADS, OVER EURUSD

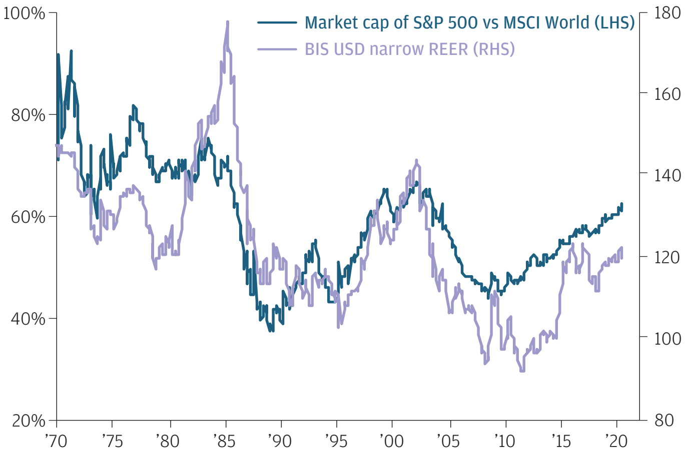


Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

However, it is also the case that US equity markets have a greater weighting towards technology and growth stocks, and that the relatively high valuation of US stocks, are well justified and that many of the sectors that appear cheap in Europe (for example, financials) represent value traps.

An improvement in investor confidence surrounding the relative outlook for eurozone equities will be important if a move higher in EURUSD is to be sustained.

EXHIBIT 3: S&P 500 MARKET CAPITALISATION AS PERCENTAGE OF MSCI WORLD AND BIS USD REAL EFFECTIVE EXCHANGE RATE



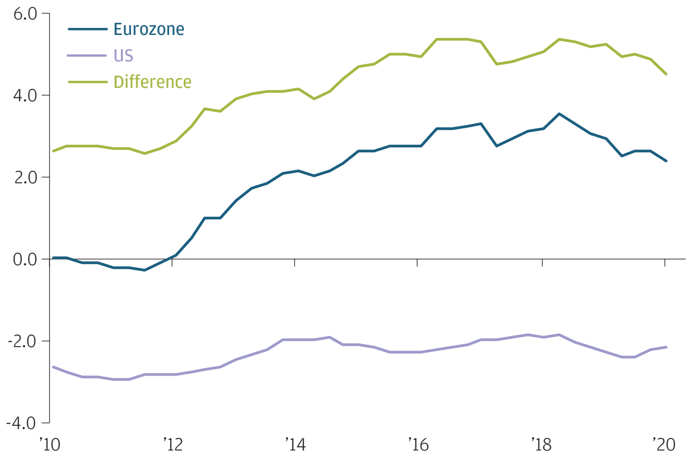
Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

The relative growth outlook between the US and the eurozone regions is likely to remain fluid and influenced by changes in fiscal policy, policy responses to contain the virus spread and the development of potential vaccines. While there remains much uncertainty, two themes have become clear. First, the European response to the virus outbreak has been more effective in containing its spread. And second, Europe has focused on protecting jobs whereas the US has focused on protecting incomes. We believe both these themes put Europe in a stronger position to recover more effectively from the Covid-19 shock in the quarters ahead as governments attempt to restart their economies.

BALANCE OF PAYMENTS ANALYSIS SUGGEST RISKS ARE SKEWED TO A HIGHER EURUSD

The eurozone has run a persistent current account surplus position in recent years vs. the US, which has run a persistent deficit position. However, our research suggests that it is the change—rather than the level—of current account balances that is the most important determinant of G10 direction. Therefore, the moderate deterioration in the eurozone's still substantial current account surplus is potentially a less supportive currency development.

EXHIBIT 4: EUROZONE AND US BALANCE OF PAYMENTS (%)

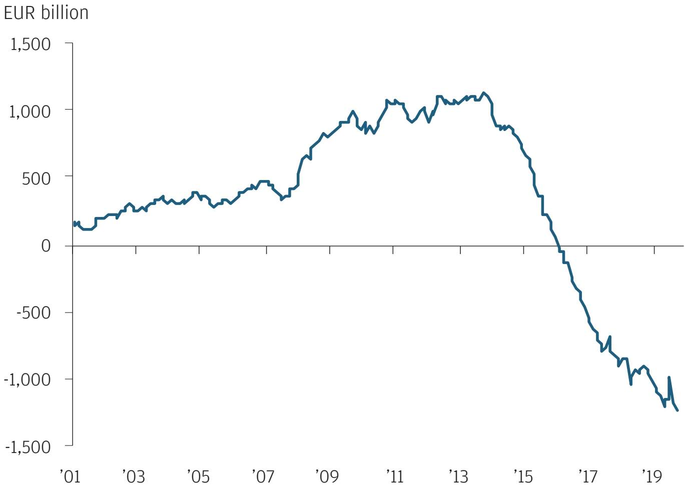


Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

Developments in the capital account, however, are more supportive for the euro. The eurozone has been a significant source of net inflows into US fixed income markets in recent years, attracted by the higher yields that have historically been available. With yields now substantially less attractive following this year's easing by the Fed, we expect flows to be less US dollar supportive and therefore we may see incremental pressure to hedge existing unhedged currency exposures.

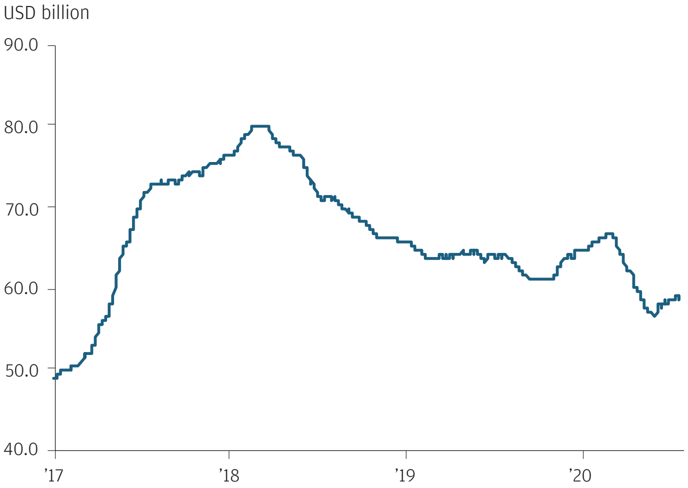
US investors have also been substantial net sellers of European equities over the past two years, exiting investments made after President Macron's election in 2017. However, as previously noted, relative valuations appear more attractive in the eurozone and, if investor confidence does become more favourable towards the eurozone, the combination of unhedged equity inflows with the eurozone's current account surplus has the potential to generate powerful upwards momentum in EURUSD. We note that our tracking of US investor flows into eurozone equity exchange-traded funds (ETFs) has stabilised, having fallen sharply in recent years, providing some evidence of a turn in sentiment.

EXHIBIT 5: CUMULATIVE BALANCE OF PAYMENTS NET DEBT FLOWS INTO THE EUROZONE



Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

EXHIBIT 6: CUMULATIVE US LISTED UNHEDGED EUROPEAN ETF FLOWS



Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

THE UNCERTAINTIES OF POLITICAL RISK

Accurately forecasting the outcomes of political events has been fraught with difficultly in recent years and therefore predictions of how currencies will react to political events in the coming quarters should be viewed with healthy scepticism. However, the 2020 US presidential election, Brexit and negotiations surrounding the European Union (EU) recovery fund are clearly events that should be considered as relevant to the EURUSD outlook.

A Democratic victory in the 2020 presidential election would clearly change the US political environment. Many believe a return to more conventional policymaking under a Biden presidency would be positive for the growth outlook. However, a Democratic victory would likely also entail increases in corporate tax rates and put at risk some of the exceptional US stock market performance of recent years. These factors could potentially result in downward pressure on the US dollar if foreigners exited US stock markets.

The path of Brexit developments remains challenging to forecast. Through the noise, it does appear the UK is headed towards a relatively hard form of Brexit, which is unlikely to see the growth drag on Europe in recent years reverse significantly.

However, the EU recovery fund does represent a potentially important source of upside for growth and asset prices in the region. The fund, as proposed, will support growth in the coming years. It also has the potential, depending on its implementation, to strengthen the institutional infrastructure of the eurozone and speed up the reform process. These reforms could see the eurozone transition from being as vulnerable as its weakest member to being as strong as its aggregate balance sheet—a development that could be rewarded positively by capital flows into the region.

On balance, we believe these political events skew positively towards a higher EURUSD, but as previously mentioned, acknowledge the challenges of forecasting FX market outcomes from political events.

IMPLICATIONS OF A RISING EURUSD FOR INVESTORS

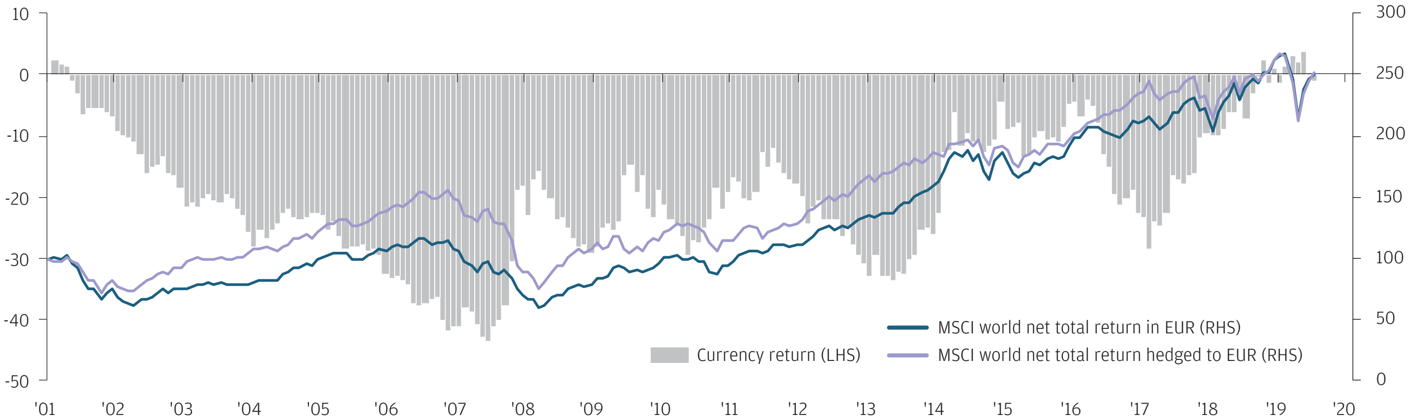
Currency returns can have a significant impact on the returns of overseas investments. For example, between December 2001 and May 2008, the difference between the compounded return of MSCI World hedged to euros (the return for the equity index excluding the currency impact) and the unhedged return (including the currency impact) was approximately 43%. The unhedged return was actually -2.4%.

This differential between hedged and unhedged returns was due to the appreciation of the euro against foreign currencies and notably the US dollar. Since May 2008 this differential has reversed, such that at present there is little overall differential between hedged and unhedged returns over the past two decades. What this highlights is that currencies tend to mean revert to fair value over long periods of time, but they can also suffer substantial shorter-term volatility.

Our view is that the euro is likely to head higher in the coming quarters and that euro-denominated investors are likely to experience FX-related losses on US dollar-based investments.

EXHIBIT 7: MSCI WORLD RETURNS IN EUR AND HEDGED TO EUR

Cumultive return (December 2001 = 100)



Source: Bloomberg, J.P. Morgan Asset Management; data as of July 2020.

WHAT CAN INVESTORS DO?

Clients should be certain that they fully understand and are comfortable with the implications of a stronger euro for overall returns. For euro-denominated investors with US dollar investments this would mean higher hedge ratios, while for US dollar-denominated investors with euro investments it would lead to a lower hedge ratio, which would be beneficial in a euro strengthening environment.

A bespoke hedge ratio study could be run to determine an appropriate hedging strategy at either a holistic or individual asset class level. In addition, there are ways to help mitigate the effects of currency movements either though passive or more dynamic risk management techniques.

EXHIBIT 8: CURRENCY RISK MANAGEMENT HEDGING SOLUTIONS

	Passive currency hedging	Dynamic "intelligent" currency hedging	Dynamic "active" currency hedging
	Risk control	Risk control and value added	Risk control and value added
Objective	• Reduce currency volatility from FX movements in the underlying assets	• Reduce currency volatility from FX movements in the underlying assets • Add longer-term value relative to the strategic currency benchmark	• Reduce currency volatility from FX movements in the underlying assets • Add value relative to the strategic currency benchmark
Strategy	• Establish optimal strategic hedge ratio (static) and currency benchmark • Implement currency forward hedges to minimise tracking error and control transactions costs • Enhanced strategy includes cash flow management and active tenor management to smooth cash flows and improve overall hedging costs	• Establish optimal strategic hedge ratio and currency benchmark • Utilise a proprietary quantitative framework to assess whether a foreign currency is cheap or expensive relative to the base currency and supported by its economic cycle • Reflect significant mis-valuation and economic momentum signals by systematically increasing or decreasing the strategic currency hedge on a bilateral basis	• Establish optimal strategic hedge ratio and currency benchmark • Utilise a proprietary multi-factor economic assessment of the foreign currencies relative to the base currency • Reflect relative macro-economic fundamentals by increasing or decreasing the strategic currency hedge on a bilateral basis
Benefits	• Low cost and effective	• A medium-term quantitative valuation-based approach to currency hedging that is low turnover and value added	• Dynamic multi-factor adjustment of the hedges reflecting both cyclical trends and longer-term considerations to add value

Source: J.P. Morgan Asset Management.

CURRENCY MANAGEMENT

Since our first segregated currency overlay mandate funded in 1989, J.P Morgan Currency Group has grown to manage a total of USD342 billion (as of 31 March 2020) in bespoke currency strategies. Our clients include governments, pension funds, insurance clients and fund providers. Based in London, the team consists of 18 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 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 offers 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.

The manager seeks to achieve its objectives, there is no guarantee they will be met. Risk management does not imply elimination of risks.

Important information

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