

WHAT AN “OVERVALUED” EURO MEANS FOR EUROPEAN EQUITY ALLOCATIONS

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The euro has recently come under attack—not from hedge funds or speculators and not in the same panic that gripped the markets following the debt crisis in peripheral European countries such as Greece, Italy and Spain. This time the attack is coming from two of the foremost central bankers of Europe. Moreover, the attack is against the continued rise of the euro against the U.S. dollar, which the European Central Bank (ECB) believes is leading to [deflationary](#) trends. At the latest International Monetary Fund meeting in Washington, Mario Draghi, president of the ECB, told journalists that the euro's strength was one of the main factors leading to [disinflationary](#) trends. Draghi believes the euro's strength knocked off between 0.40 and 0.50 percentage points of [inflation](#) over the past 18 months.¹ “The strengthening of the exchange rate requires further monetary stimulus,” Draghi said. “That is an important dimension for us.” But Draghi isn't the only leader of a European central bank concerned with the strength of the euro. The head of the Swiss Central Bank, Thomas Jordan, tied his fate to the euro following the financial crisis, when money flowed to Switzerland, causing the Swiss franc to show incredible strength as a [safe-haven](#) currency but leading to deflationary pressure and putting recessionary pressure on Switzerland. The Swiss National Bank (SNB) took a bold step of capping the Swiss franc at 1.20 per euro in September 2011. Now Jordan thinks the euro is overvalued, again putting pressure on Switzerland's economy. Jordan said, “The Swiss franc remains highly valued, and in order to maintain adequate monetary conditions in Switzerland so that we can maintain price stability, and in order to not fall back into negative inflation, we have to maintain the minimum exchange rate. ... We have a strong euro against the dollar, and we have an even stronger Swiss franc against the dollar, so what we need is probably both a weakening of the Swiss franc and a weakening of the euro against the dollar.”² The question is, what will the ECB do, besides talk tough about the euro causing deflationary trends? The ECB's balance sheet has been shrinking—more a sign of financial [tightening](#) conditions than monetary easing—as banks repay their [long-term refinancing operations \(LTRO\)](#) programs that were enacted during the crisis period. The ECB has shown reluctance to engage in further [quantitative easing \(QE\)](#) programs or expand its balance sheets by buying assets such as government bonds. The political situation in Europe is complicated, in that, achieving a consensus among central bank governors spread across Europe is very challenging. Recent supportive comments from [Bundesbank](#) head Jens Weidmann mark a “radical softening” of the German Central Bank's stance with respect to QE.³ Austria's Central Bank head, Ewald Nowotny, has also suggested that QE should not be off the table.⁴ But the European Union (EU) framework itself imparts additional questions in regard to [sovereign debt](#) purchases. One economist has suggested the ECB buy U.S. treasuries with additional QE, as there would be no favoritism being shown in what countries' bonds were selected and no fears about [monetizing](#) government deficits, and it would have the effect of directly countering fears of an overvalued euro. Yet this is not the route the ECB is leaning toward. Going to a **Negative Deposit Rate** Rather, the talk is twofold. The ECB seems to prefer targeting purchases of [asset-backed securities](#) and possibly looking to implement a negative deposit rate. Supporting securitized loans while also placing a tax on deposits

at the ECB would potentially create incentives for banks to expand their lending programs and refuel expansionist policies. **Implications for Equity Investors** All this talk about taking additional monetary policy measures to counter the deflationary trends caused by the euro's strength leads to a natural question: What about the large flow of assets that has gone toward European equities banking on a growth recovery? The vast majority of the investment products in the United States targeting exposure to Europe should consider two sources of risk: 1) **Equity Market Risk**: Exposure to movements in local European equity market prices 2) **Currency Risk**: Exposure to the movements of the euro and other European currencies such as the Swiss franc and the British pound against the U.S. dollar why take the additional currency risk when the head of the ECB is telegraphing very plainly that he does not want to see the euro appreciate much further and, if it does, he will take action? Further ECB monetary easing could be beneficial to growth in the economy, helping companies' profits. But these programs potentially render the currency exposure a source of unrewarded volatility. Therefore, one should very strongly consider currency-hedging European equities. If this sounds familiar, it should. This was a central case in 2013 for Japan, a country that has seen the strong yen fuel a cycle of deflationary trends for much of the last 15 years. The head of its central bank unleashed an unprecedented monetary easing program to dislodge deflation and was rather successful, seeing the beginnings of an inflationary cycle in the first year. Current inflation readings in Japan are three times the inflation levels of Europe (1.5% inflation in Japan versus 0.5% inflation in Europe).⁵ No one is expecting Draghi to embark on as bold a program as the Bank of Japan, but at least he seems to be moving in that direction. This can be seen as a positive step for the eurozone, but again, why would one want to assume euro risk when seeking to access exposure in this region? ¹Source: Chris Giles and Claire Jones, "ECB Preparing to Unleash Unconventional Monetary Policy," Financial Times, 4/12/14. ²Stefan Riecher and Catherine Bosley, "Jordan Says SNB Minimum Exchange Rate Extremely Important," Bloomberg, 4/14/14. ³Source: "Weidmann Says ECB Quantitative Easing Not Out of the Question," Reuters, 3/26/14. ⁴Source: Kiran Moodley, "Nowotny: Strong Recovery Will Ward Off Deflation," CNBC.com, 4/11/14. ⁵Source: Bloomberg, with Japanese inflation measured by the Japan Nationwide Consumer Price Index and European inflation measured by the Eurozone Consumer Price Index. Most recent available data as of 3/31/14.

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DEFINITIONS

Deflation..: The opposite of inflation, characterized by falling price levels.

Disinflation..: Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Inflation..: Characterized by rising price levels.

Safe-haven..: Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

Tighten..: a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Long-term refinancing operations (LTRO)..: Means by which the European Central Bank was able to provide liquidity to the European financial sector.

Quantitative Easing (QE)..: A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Bundesbank..: The central bank of the Federal Republic of Germany.

Sovereign Debt..: Bonds issued by a national government in a foreign currency, in order to finance the issuing country's growth.

Monetizing..: When a central bank purchases debt with the consequence of increasing the money supply.

Asset-backed security..: A fixed income security whose value or cash flows depends on the value of another asset, such as a loan, lease, or receivable.

Risk..: Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.