Euro Analysis

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The Euro

2016 has demonstrated in full the immense impact that political factors can have on the global economy and financial markets. The United Kingdom's decision to leave the EU following its referendum on the 23rd June led to the biggest one-day loss in the history of the British Pound. Meanwhile in the United States, the country was preparing for one of the most exciting elections in recent history. Most had expected a Trump win to lead to substantial dollar weakness, as investor confidence in the businessman was low. In reality, subsequent digestion of his planned policies, such as an increase in fiscal stimulus, saw the dollar index perform strongly in the month after his election. Evidently, 2016 has been an exciting year in the foreign exchange market.

Attention now turns to Europe as political factors continue to dominate the economic calendar for the next 12 months. In early December, Italy will be holding a constitutional referendum that will likely shape the future of the country's government. Similarly, Germany, France and The Netherlands will all hold important elections in 2017 that are likely to have a profound effect on the political and economic landscape in Europe. This report will aim to analyse what the impact of these events and others will be on the short to midterm future of the Euro.

Brexit

One of the most important factors in determining the value of the Euro in the coming months will be the progression of EU negotiations with the UK. This comes after the United Kingdom's shock decision to vote to leave the European Union on the 23rd June 2016. The widely unexpected 'Brexit' caused EUR/GBP to climb to highs of 0.8315 on the morning of the announcement (up from 0.7611). As the news unfolded, uncertainty over the economic future of the UK meant the pound drastically tumbled as investors sought to move their assets out of Sterling towards seemingly safer currencies.

With Theresa May stating a deadline for triggering Article 50 by March 2017, talks are currently underway in the courts and between leaders to navigate Britain's future relationship with the European Union. A key issue is whether Britain will automatically lose its European Economic Area membership, which permits free trade with the single market in return for budget contributions and free movement of labour. Leaving the EEA altogether, referred to as one of the components of a 'hard Brexit', would mean the UK ceases to trade freely with the rest of the EU and instead under the terms of trade governed by the World Trade Organisation. In the absence of free trade, there will likely be tariffs placed on all goods and services traded between each other, making trade more costly and difficult. If the Supreme Court rules that the government can have final say over Brexit decisions, more likely resulting in a hard Brexit, then we would expect to see increases in EUR/GBP due to sell offs in Sterling from investors, as they question Britain's economic stability outside the single market.

On the other hand, a 'soft Brexit' which permits access to the single market, would lead to a weakening EUR/GBP rate as the Pound would strengthen. This is a possibility that was widely ruled out by EU representatives in the earliest stages of negotiations, but there are signs this sentiment is being reversed. We believe GBP has been too aggressively undervalued in the months post-Brexit and this trend will soon reverse, which, coupled with a higher risk premium on the Euro due to political uncertainty, may push EUR/GBP substantially down from current levels. Although GBP also suffers from political uncertainty regarding the forthcoming Brexit negotiations, it may be regarded as a more attractive alternative to the Euro given the increased risks that single currency could disintegrate altogether given the increasing fragmentation we are seeing across Europe.

Trump

On the other side of the Atlantic, the world watched in disbelief as Donald Trump was voted the new president-elect of the United States of America on November 8th. The Eurozone stood in fear of its future, as it saw the demand, and so value of its currency, plummet to more than 18 month lows. Since the financial crisis, the weighted economic contribution between countries within Europe has slowly decreased; with southern countries relying on larger nations such as Germany and ECB QE schemes for financial support. This uneven balance has been weakening the connections between European nations, with many now contemplating independence from the EU. With these processes already taking place, to what extent is Donald Trump's rise to power a catalyst to this splintering?

One of Trump's main policy objectives is to implement huge fiscal measures within the US, aimed at increasing GDP growth. With increased growth comes inflation, and so the Fed is almost certainly expected to increase interest rates this year. A rate hike means we are more likely to see capital flock to the U.S. as investors search for yield. Due to the political and financial risks in the Eurozone, any Dollar strength is likely to exacerbate Euro sell-offs.
Trump, along with Brexit, has also sparked major political uncertainty amongst investors, which has massively impacted the upcoming elections within Europe. The unexpected rise of Trump directly reflects the increased power of populist parties across the globe, and as a result currency markets are taking note of the extra uncertainty. With the upcoming European elections, many investors believe that there is a higher chance of these party leaders, who are in favour of EU independency, rising to power. In line with the view that the market prefers consistency and certainty, these elections may also be a bad sign for the currency.

Another factor to also be wary of is the trade relationship Trump keeps with the EU, as there is speculation surrounding a freeze of the Transatlantic Trade and Investment Partnership (TTIP), which in turn could add stress to the EU's current account. As the US is the main trading partner of the Eurozone, any abolishment of the TTIP is likely to add to Euro weakness.

Italian Referendum

Following on from the juggernaut political decisions in the form of Brexit and the US presidential election, attention now turns to Italy and their upcoming referendum. Matteo Renzi, Italy's current prime minister, has proposed a constitutional reform of their law-making houses. The current system gives equal power to both the upper house, the Senate, and the lower house, the Chamber of Deputies. Renzi proposes a reduction in power and size for the Senate, in theory tackling the political gridlock faced in Italy between the two houses.

So how does this affect the Euro and what impact will the result have on the markets? A defeat for Renzi means the reforms won't go ahead AND Renzi will step down from his prime ministerial role. This in turn could lead to early elections and a rise in support for the populist Five Star Movement (M5S). M5S, led by Beppe Grillo, has become the democratic party's largest opposition in recent years and pledges to carry out a referendum on whether Italy should stay in the Euro area. Investors and economists alike see Italy as the final piece to fall in sustaining the EU and this could be the start of the end of the single currency system. Obviously if events were to go this far in the future this would be a disaster for the Euro and we could see huge sell offs up to and around the referendum result.

If Renzi were to win on Sunday 4th December, the political certainty alone would lead to Euro strength across currencies as we should reverse some of the downside seen since the US election. Further in the future it is hoped that with the new reforms in place Italy can stimulate growth again, reduce bad loans and remove their expensive protection laws. This should lead to longer, stronger market sentiment for the Euro in the upcoming year.

French Election

France go to the polls in April next year to begin voting in an election which also has the potential to significantly shape the future strength of the Euro. The three main political parties heading into election year are the Socialist party, the Republican party and the Far right anti-immigration party, The National Front. The populist movement, led by Marine Le Pen has been gathering momentum due to her focus on anti-immigration policies and promise to call a French referendum on EU membership. Terrorist attacks in 2016 on French soil have only boosted her campaign by adding further paranoia into the hearts of the French electorate. In a recent opinion poll, 74% of conservative voters claimed they would vote for Le Pen, a clear shift in political sentiment from decades of centrism, to right wing politics.

A win for Le Pen's National Front party is likely to cause tremors across the financial markets. Like Brexit, it would represent yet more anti-EU sentiment, and a referendum win would almost certainly lead to the introduction of greater protectionist policies. With exports of goods and services compromising c. 30% of French GDP, economic growth would likely take a hit as a result. We anticipate this leading to downward pressure on the Euro as investors lose confidence in the country as a place to business with access to the single market. An alternative scenario in the short term involves Euro price movements dominated by self-fulfilling trades. Prediction of the aforementioned price movements by 'behavioural' traders, may lead to Euro sell-offs as soon as market sentiment moves towards a Le Pen victory - without proper consideration for the underlying fundamentals. This could lead to a situation like that seen in the US in November, where initial losses for the home currency are reversed as the market reconsiders the intrinsic value of the currency.

A win for the other established political parties would more likely lead to Euro gains in the short term as restoration of the status quo calms investors. Francois Fillon, leader of the centre right republican party, is currently holding a several percentage point lead over Marine Le Pen. If polls continue to suggest this outcome heading into the new year, then the Euro's price will remain relatively stable. However, with Brexit and continued growth in populist movements across Europe, uncertainty surrounding a Le Pen win will quickly be incorporated into currency pricing. This could result in the Euro being very undervalued against other major currencies in the run up to election day. In the immediate aftermath of the election, a Le Pen victory could cause a mass selloff in the Euro leading it to fall significantly against other major currencies.

German Election

In Germany, more and more citizens have criticized Angela Merkel's open door policy of immigration. There is growing sentiment that people might look to vote for Alternative fur Deutschland(AFD). AFD expresses that it will lead the country to leave the Eurozone and the EU if it wins the elections; continuing the trend of growth in anti-establishment parties. AFD remarkably won representation in 10 out of the 16 German states in September. By contrast, Merkel's party, the Christian Democratic Union (CDU), suffered huge defeats in the local elections. On top of that, Germany's Christian Social Union, CSU - a current partner of CDU - oppose Merkel's immigration policy. The leader of the CSU has said that he wants to limit the number of refugees entering the country. Questions therefore remain over the stability of the CDU/CSU alliance. Investor's will be keeping an eye on the CDU party congress at the beginning of December. If the relationship is unsustainable, CDU may have to find other parties to make an alliance if Merkel is to become the next chancellor. Otherwise, an AFD victory generates more uncertainty over Germany's relationship with the EU, thus putting more downward pressure on the Euro.

Figure 1 - EUR/USD August-Oct 2005

To provide some context, we can analyse the situation in a German election over a decade ago. Either CDU/CSU or the Social Democratic Party (SPD) were in line to win the election. Policy about the EU was a key part of the agenda then too, and this sentiment was reflected in investor behaviour as shown in figure 1 - Euro sell-offs. This pushed EUR/USD down from over 1.25 on the 1st September to near 1.21 on the 19th September. The election result - where neither CDU/CSU or SPD earned over 50% of seats in Parliament - further increased uncertainty about what EU policy would be pursued and made EUR/USD drop to near 1.19. Only until there was a coalition government formed on the 3rd October did the Euro recover some of its losses. This demonstrates the importance of EU related policy decisions by the major member countries on the price of the Euro.

Dutch Election

Like France, the Netherlands are also set to hold an historic vote early next year. The forerunning parties are the People's Party for Freedom and Democracy (VVD), led by the current Dutch Prime Minister Mark Rutte, and the far-right Dutch anti-immigration Party for Freedom (PVV), led by Eurosceptic Geert Wilders. Most recent polls show Geert Wilders holds a lead over the current prime minister's party. This further demonstrates the growing dissatisfaction amongst Europeans with the current political system.

After Ireland, no country in the Eurozone has closer economic and financial ties to the UK, with the Netherlands investing heavily in the UK. Royal Dutch Shell and Unilever are both examples of successful Anglo-Dutch multinationals. Therefore, whilst the Netherlands remain within the EU, it is within their interests to provide an attractive trade deal to the departing UK, thus making it more appealing to the Dutch people for a possible 'Nexit'. However, as one of the world's biggest exporters and an integral EU member at current, any departure from the EU and the Euro would be a long and complicated process. Consequently, a win for Geert Wilders' party would likely add downward pressure to the Euro and could also give momentum to Le Pen in France the following month, and AFD in Germany later in the year.

A chain reaction of events as above would dramatically reduce business and investor confidence in the Eurozone, as fewer investors would be willing to invest in the increasingly politically unstable Europe. An unstable Europe could spell the end of the single market as we know it.

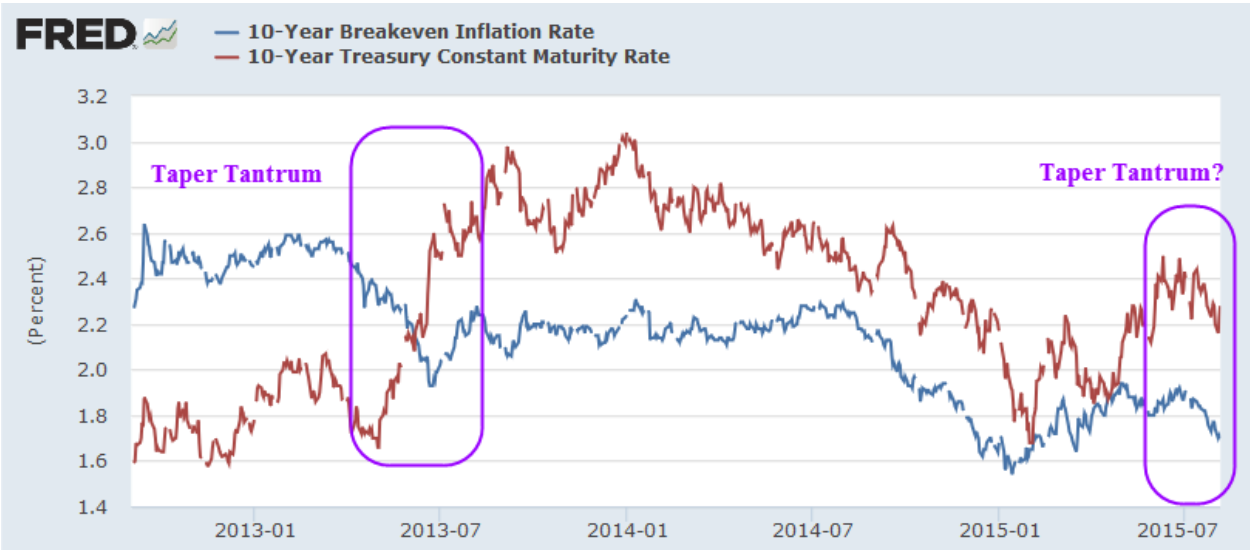
Q.E.

The ECB plans to continue its asset purchasing programme until at least March 2017, with the total value of bonds purchased since its inception in January 2015 exceeding €1.3tn as of December 2016. Comments made by ECB president Mario Draghi on November 27th suggest that the ECB will strive to ensure that policy is accommodative enough to boost inflation in the Eurozone. Such rhetoric fuels speculation that the ECB will announce a continuation of its QE programme as early as Thursday 8th December when they next meet. Concern that economic and political uncertainty in the EEA will lead to a slowdown in economic activity, is likely to be at the forefront of Draghi's mind. Therefore, an injection of funds into this region may be a necessary policy tool.

Of particular concern is Italy, who are already suffering from non-performing loans. Fears that a 'No' vote in their upcoming referendum could generate yet more uncertainty were reflected by a 3.05% dive in the FTSE Italia All-Share Banks Sector Index on 29th November. It may be that the ECB needs to step in to purchase the country's debt to keep interest rates low, necessitating the continuation of QE. Indeed, it seems highly unlikely that in times of such political risk that the ECB will retract a measure specifically designed to stimulate the economy during periods of uncertainty. This sentiment is reflected in a recent Reuters poll where 52 of 60 economists said the ECB will announce on December 8th an extension to its Q.E. program beyond the current plan of March 2017.

However, Draghi has not ruled out the possibility of tapering the number of bonds purchased monthly, from €80bn to €60bn a month. This appears to be a lose-lose for the Euro; a tapering of QE is likely to negatively impact investor confidence as observed during the 2013 'taper tantrum' in the US (Figure 2), which resulted in hefty rate spikes. These higher borrowing costs could undermine the work of the ECB since January 2015 by causing firms in the Eurozone to cut back on investments and other growth opportunities. This is likely to trigger a bearish stance amongst investors on short to medium timescales, as uncertainty over the future of European manufacturing sets in. If tapering of QE were to be announced on Thursday 8th, the markets will likely rapidly reflect this sentiment.

Figure 2 – 'Taper Tantrum'



On the other hand, extending QE is also likely to have a negative impact on the short-term value of the Euro. As demonstrated by QE programmes in Japan, the U.S. and the U.K., the external value of the currency being 'printed' suffers as a direct result of unnaturally increased supply. However, in the long term, it will serve to

push inflation in the Eurozone towards the 2% target and will keep interest rates low, while negating some of the uncertainty posed by a highly volatile political environment. This may serve to benefit the Euro over the next year or two. The ECB next meet on December 8th, and it is likely that the markets will start pricing in the predicted outcome at around this time, based on the decision that is made.

Conclusion

Our analysis of the various factors has pointed us in the direction of a few conclusions. The short-to-midterm future of the Euro is most likely to be clouded by the uncertainty of ongoing and upcoming political factors across Europe, as well as in the UK and the USA. Given the political events that have transpired over the last few months, current speculation focuses on the potential rise of populist parties in Germany, France, Italy and The Netherlands. A common point on the agenda of these parties regards independence from the EU. Our analysis has shown that this is most likely to result in downward pressure on the currency, as a result of destabilisation within the union.

Following from this, the uncertainty of Brexit still looms and this is likely to impact the volatility of the currency in the near future. Depending on the terms agreed between the UK and the EU, there are a plethora of outcomes that could occur; each having its own impact on the value of the currency. This uncertainty is likely to be priced into the currency, reflected in near-future periods of volatility. Coupled with the inflow of capital into the USA as a result of Trump's proposed 'pro-US' policies, this volatility is likely to be increased in magnitude.

These characteristics surrounding the near-term future of the Euro lead us to believe that there is a significant amount of investor-pessimism and, as a result, an outflow of capital. This would put further downward pressure on the Euro in a negative way, and consequently, performance of the currency looks weak in the short to midterm horizon.