

# The 2010 Euro Outlook

January, 2010

Kathleen Stephansen

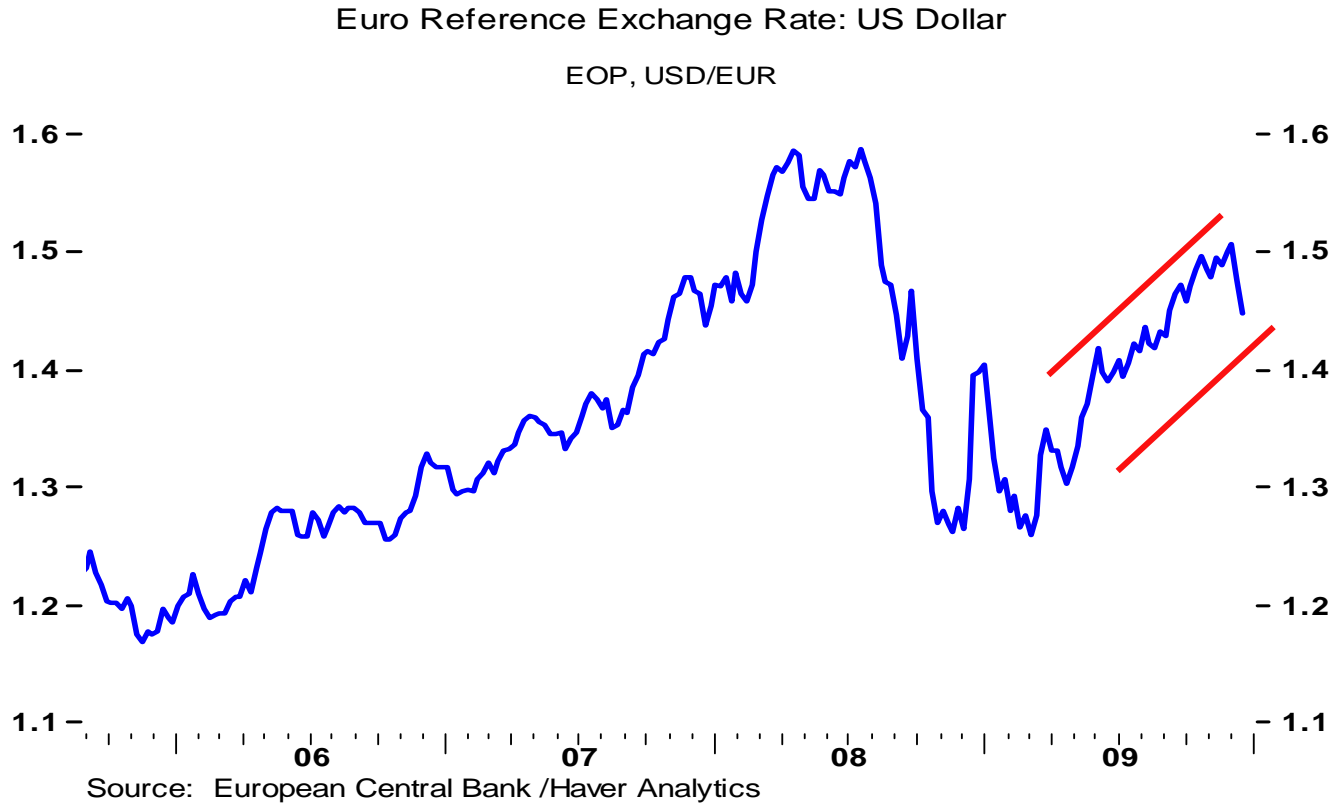
Chief Economist



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# Euro/USD: where to?



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# The Euro Outlook

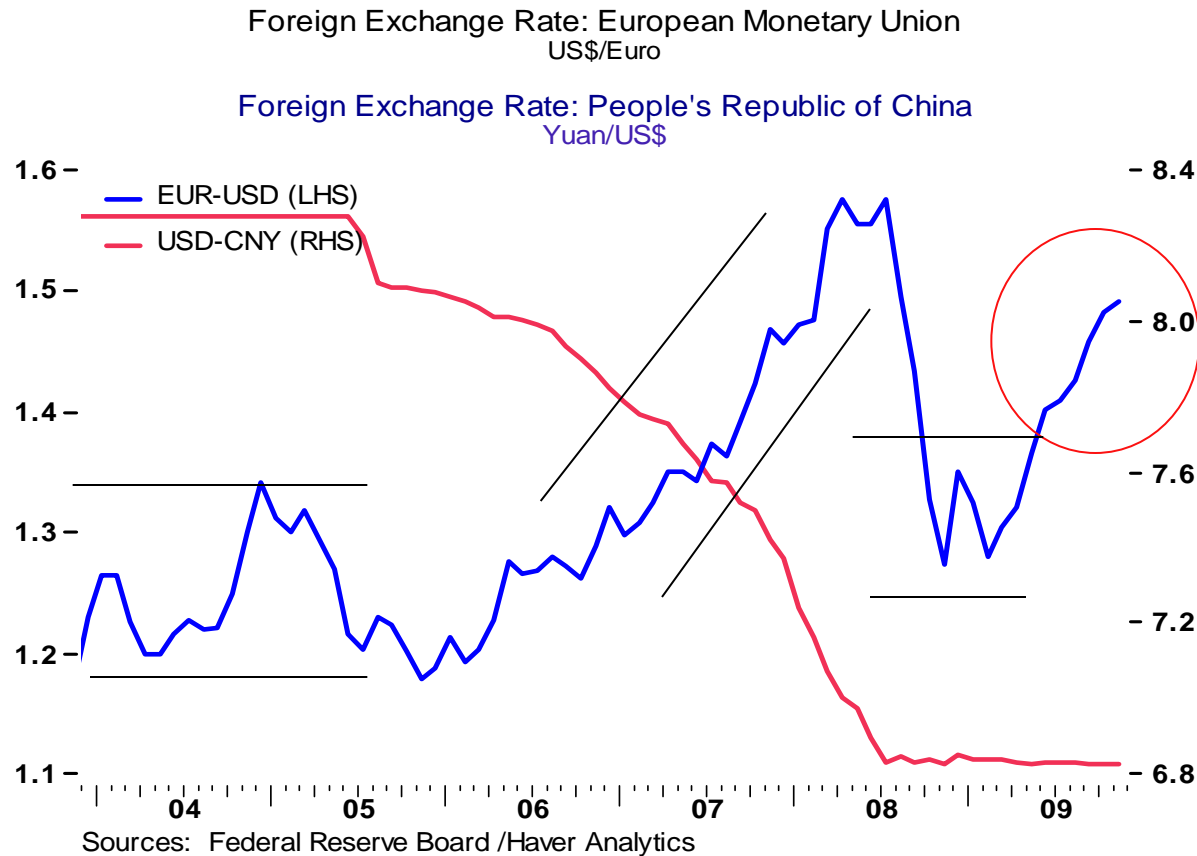
- We believe the Euro-USD will be in a relatively tight range over the next 12 months, ending the year close to 1.50.
- Volatility is likely to dominate currency markets and the EUR-USD in particular, given the tension between positive and negative factors.
- The crisis has set in motion a more rapid adjustment in global imbalances. We believe that the dollar is in a longer-term downward trend, adjusting to capital flows being directed to emerging economies and leading to reserve diversification that accompanies this adjustment.
- Historical perspective: The Euro has been a success. The challenge ahead is to restore growth without the benefit of the demand impulse from the peripheral countries.



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The end of the 2005 CNY/USD peg coincided with a sharp appreciation of the Euro/USD and is the manifestation of a currency redistribution away from the dollar.



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# Positive Euro factors

- Global rebalancing
- Global FX diversification away from the USD;
- Global liquidity;
- Return to risk appetite;
- The timing of the ECB monetary policy exit.



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# Structural changes

In adjusting to credit restraint, de-leveraging and restructuring of debt, private demand in the G-2 (US & UK) could be a restraining factor to the positive multiplier effects of recovering trade flows.

Specifically, we believe in the de-emphasis of the US consumer.

The burden then shifts to China to redirect its drivers of growth away from exports to domestic demand. This process has started already but will gain traction in years to come. We note that the other two major surplus/saver countries, Germany and Japan, show even smaller inclination than China in relying on consumption to drive growth.

This is a multi-year process demanding infrastructure build, followed by diversification towards services and consumption industries.

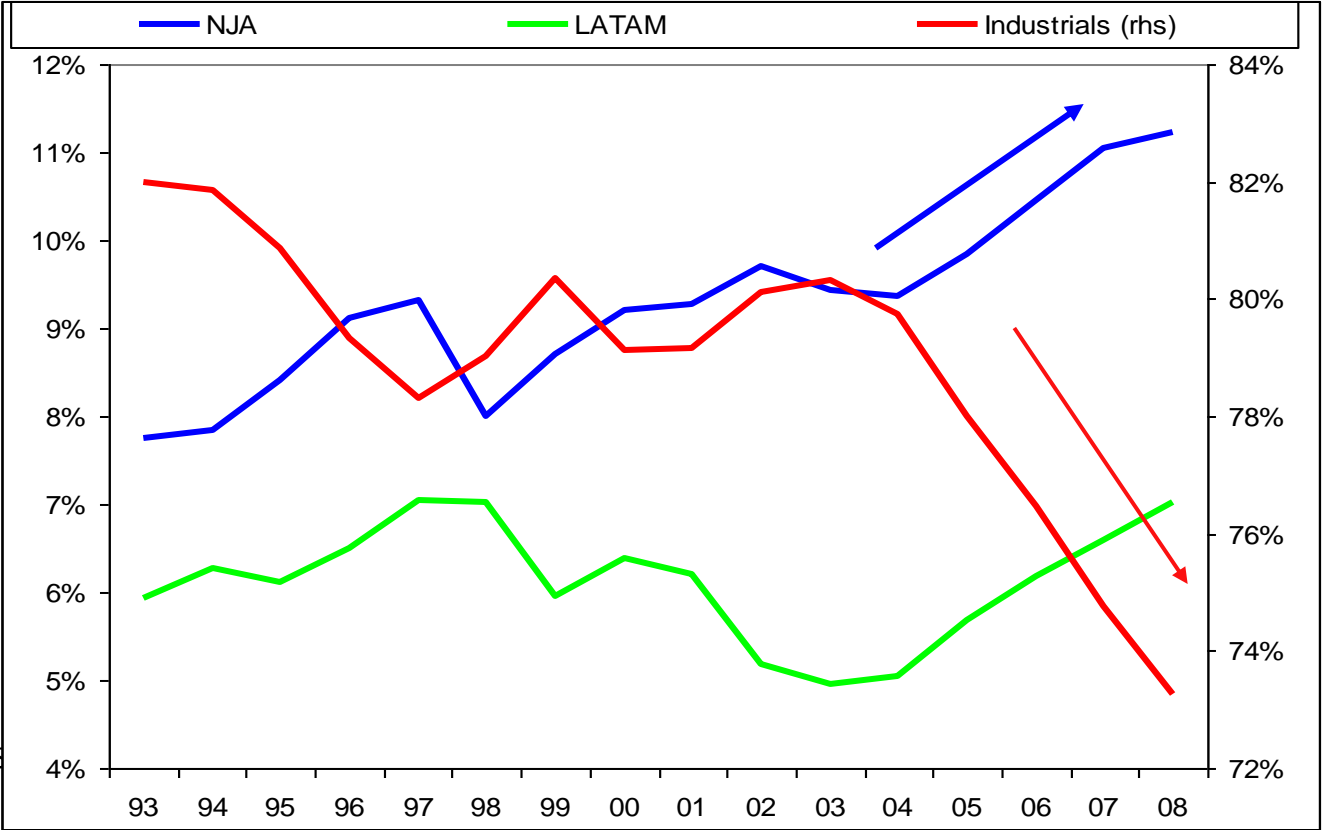


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# Marked decline in the share of industrial countries' consumption to global consumption

Shares of Regional Consumption to World Consumption



Sources: DataStream International; IMF; OECD

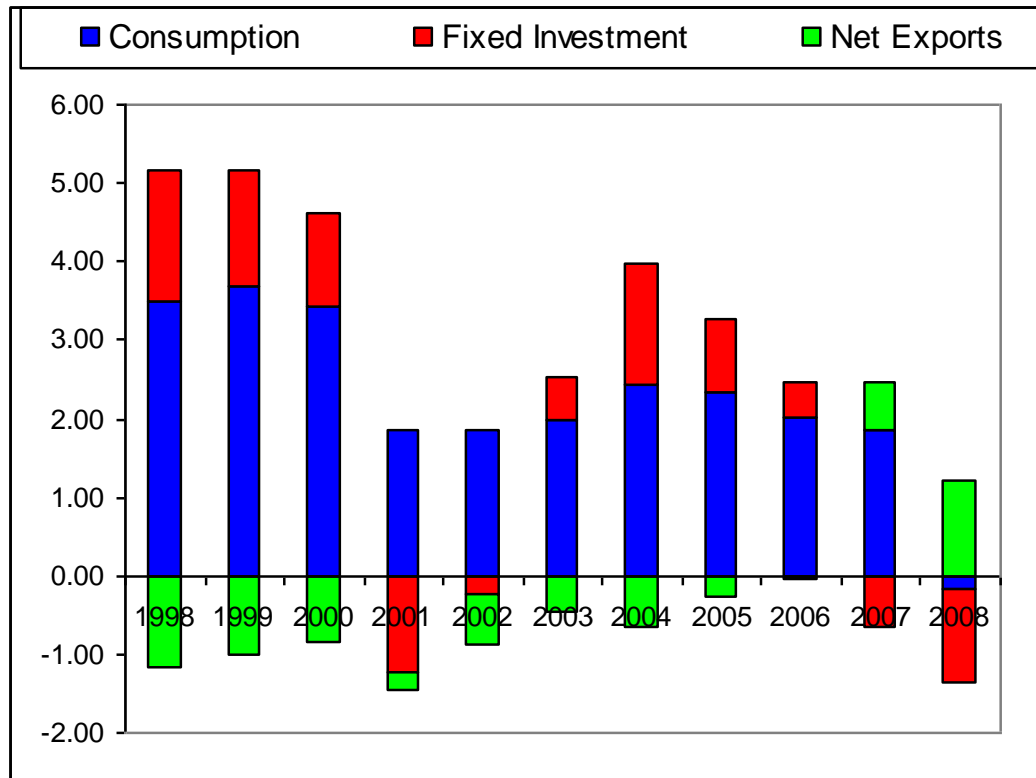


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# US: Consumer-led growth is set to change

Sector contribution to real GDP growth



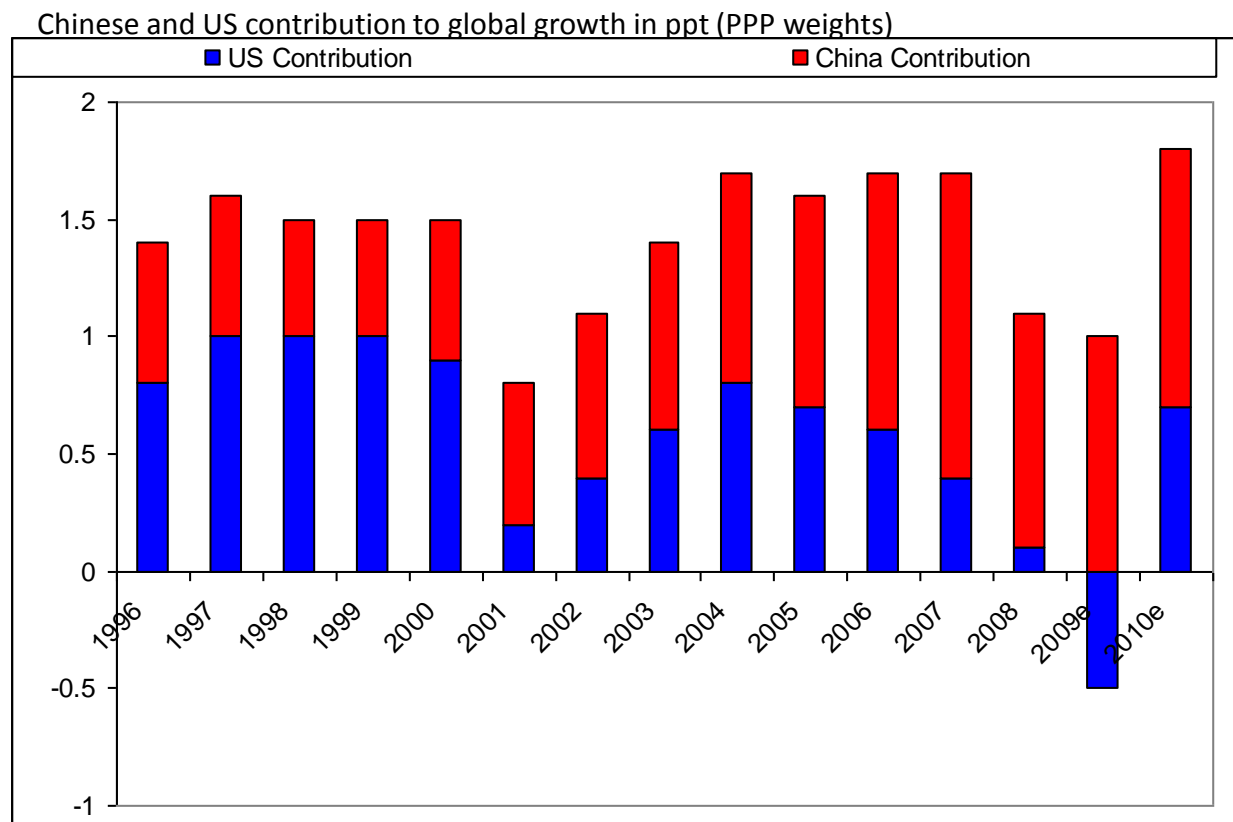
Sources: BEA/Haver Analytics



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It is a dynamic we saw with China, whose contributions to global growth has risen steadily this past decade



Sources: IMF/Haver Analytics

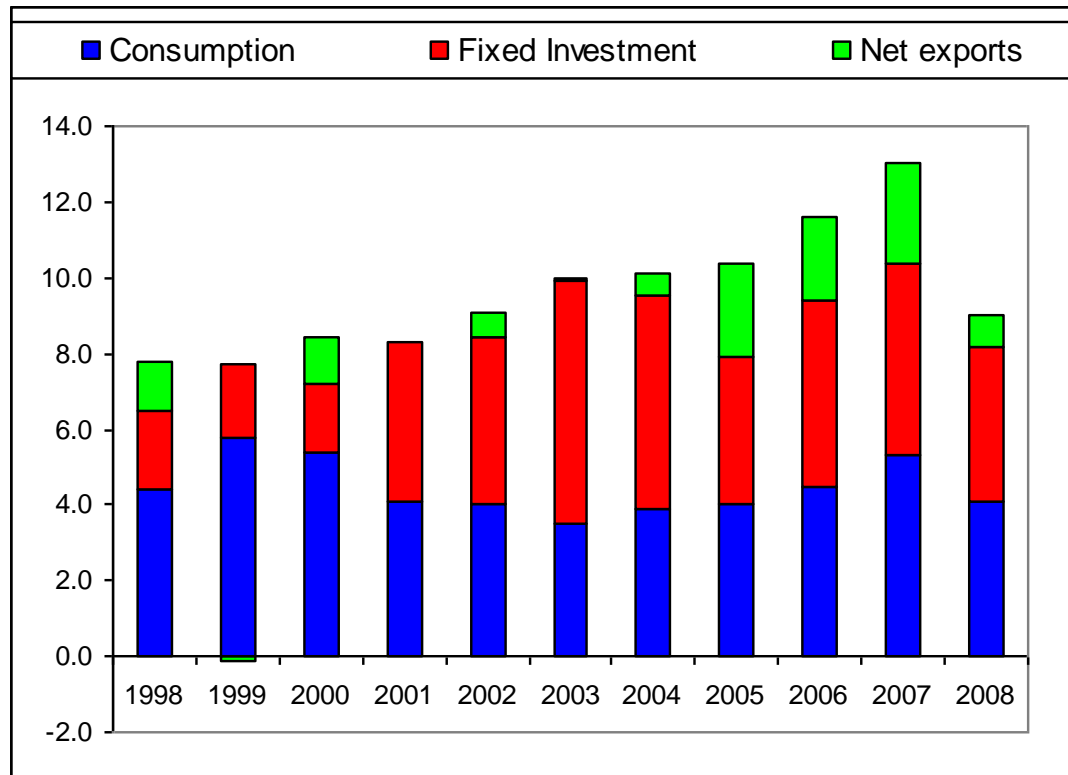


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# China: The massive infrastructure build was first related to the 2008 Olympics, then to the development of the domestic economy

Sector contribution to real GDP growth



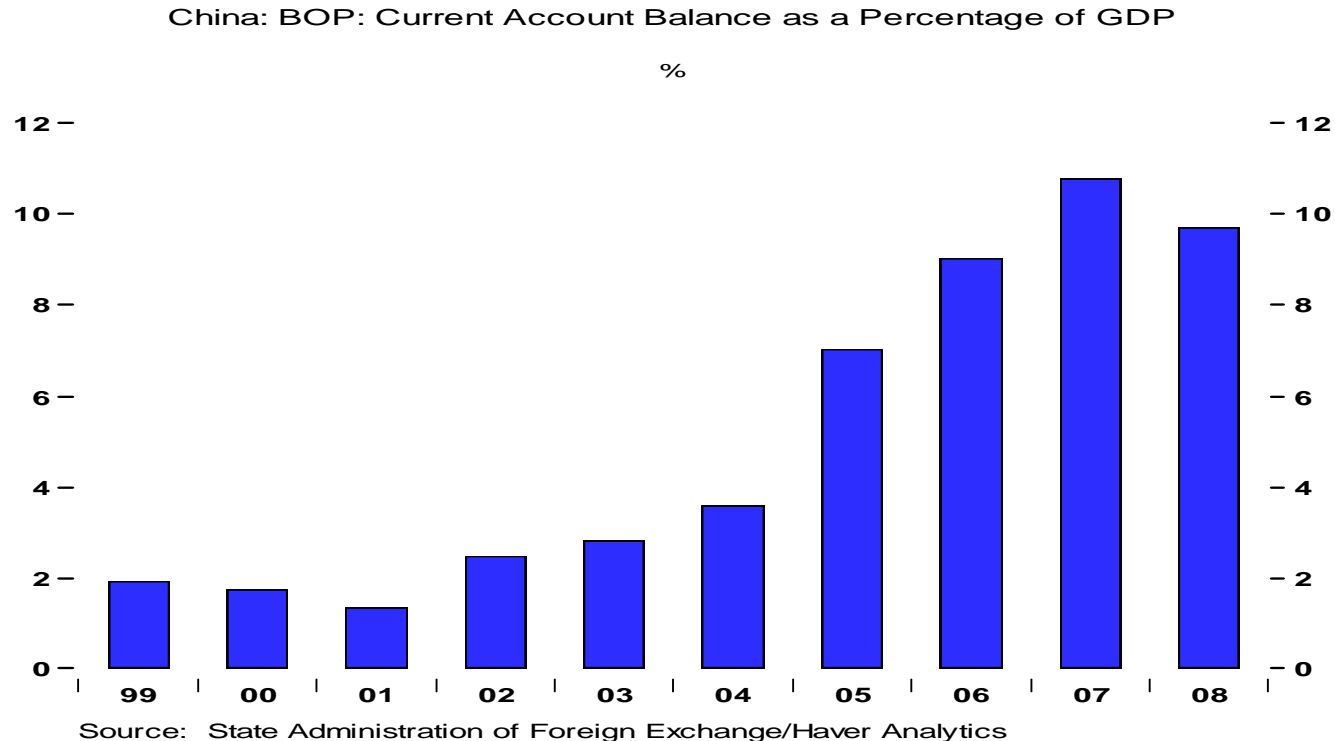
Sources: China National Bureau of Statistics/Haver Analytics



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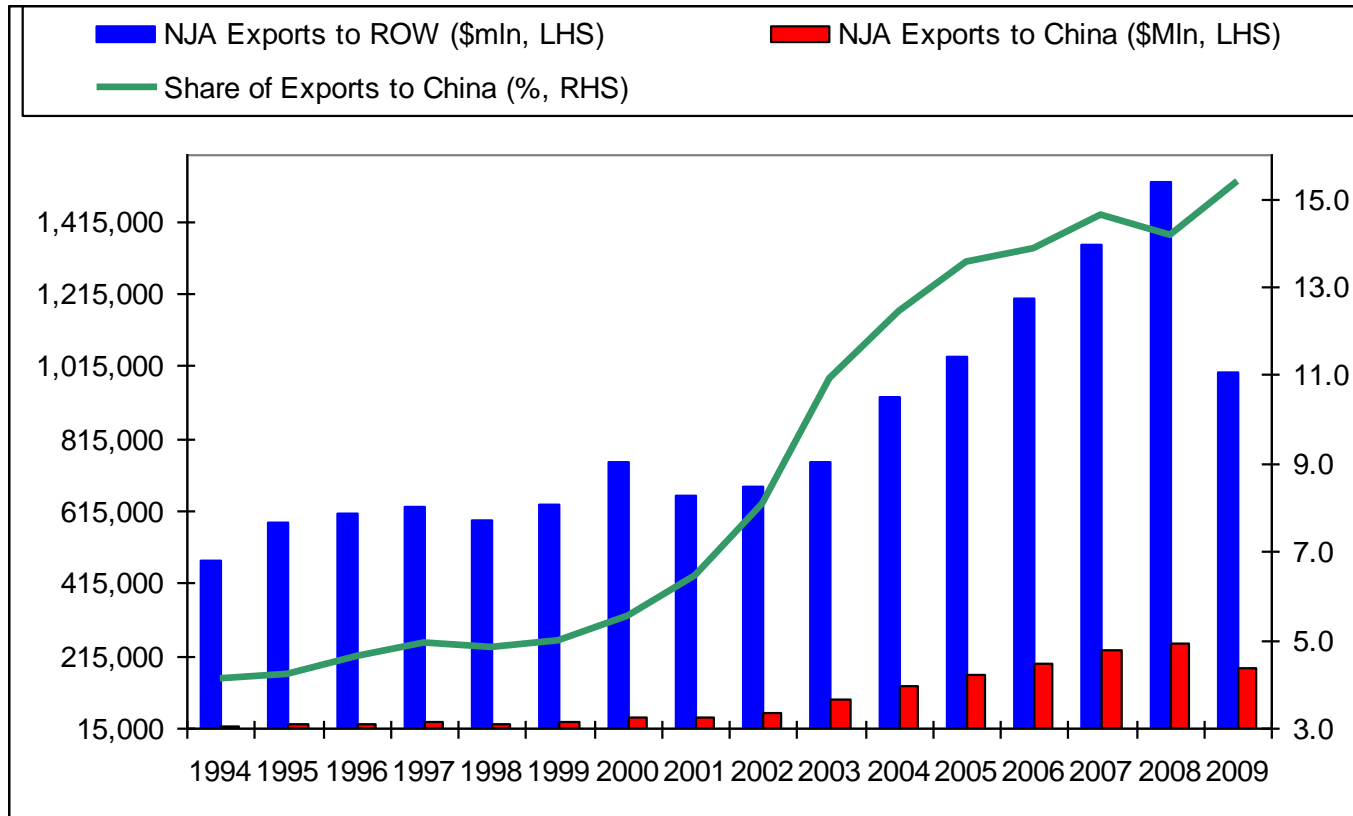
# China's current account surplus should decline, implying less aggressive purchases of US Treasuries, and a slowdown in demand for dollars



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As Chinese demand continues to rise, it increasingly benefits NJA. NJA export share to China tripled over the period 1998-2009, jumping to 15.4% in 2009 from 4.8% in 1998



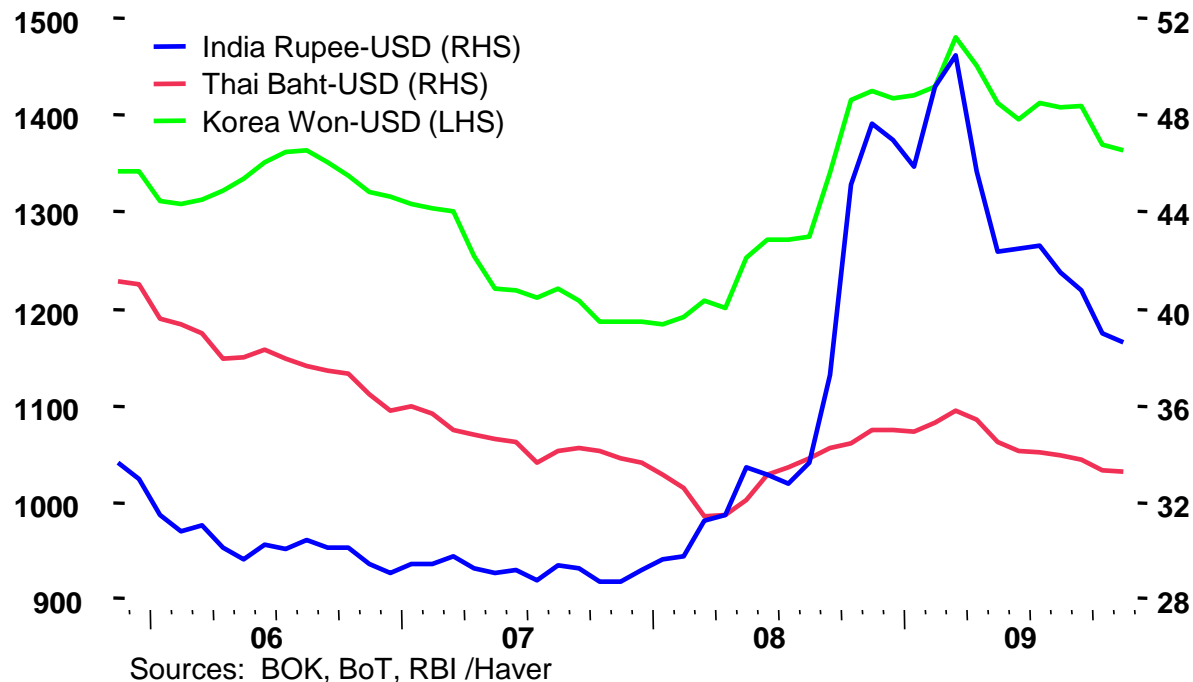
Note: 2009 statistics cover the first 10 months of the year  
Sources: Datastream



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Upward pressures on Asian currencies against the USD implies intervention, thereby limiting the decline of the USD. A shift in trade flows would lead to FX reserve diversification

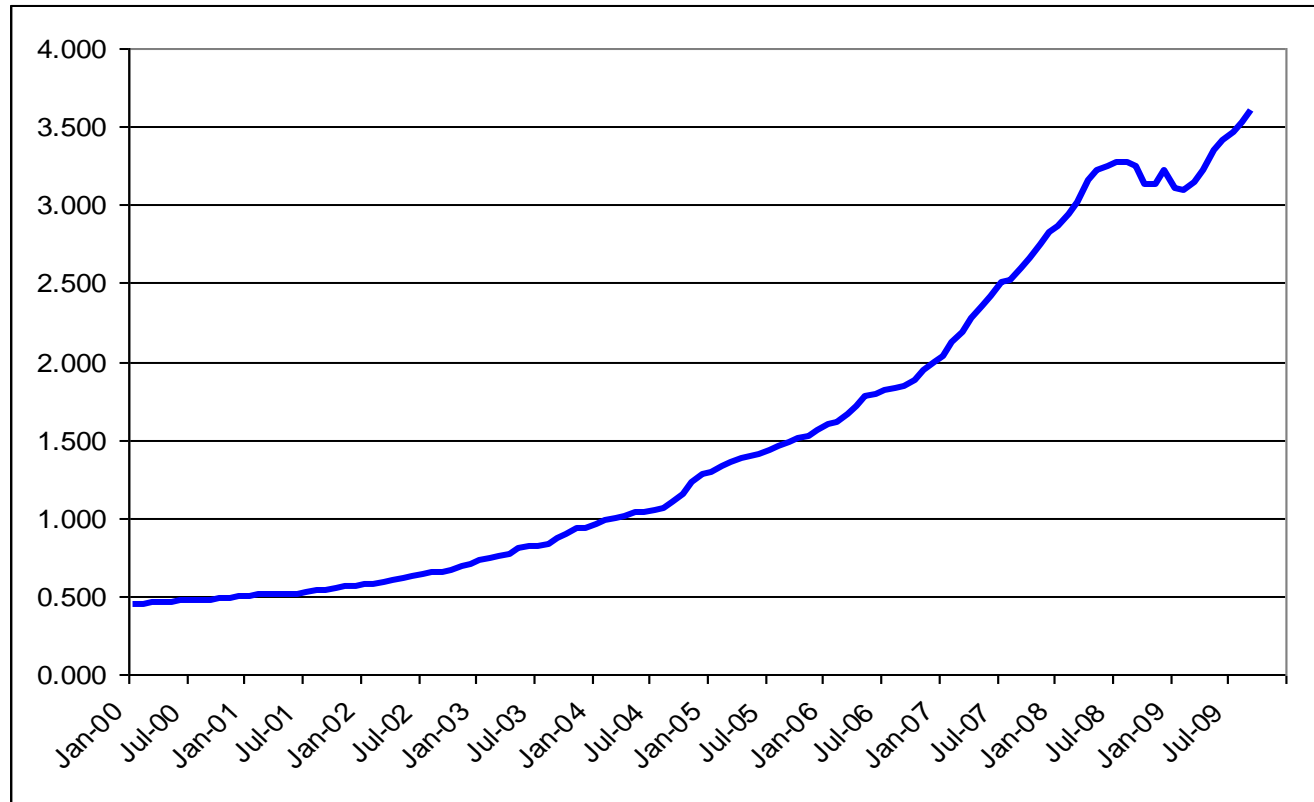


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# EM countries, whose currencies are under upward pressure, incur FX reserves accumulation that is set to continue

Intl Liquidity: EM Foreign Exchange (NSA, EOP, Tril.US\$)



Sources: Bloomberg Financial Markets/Haver Analytics/

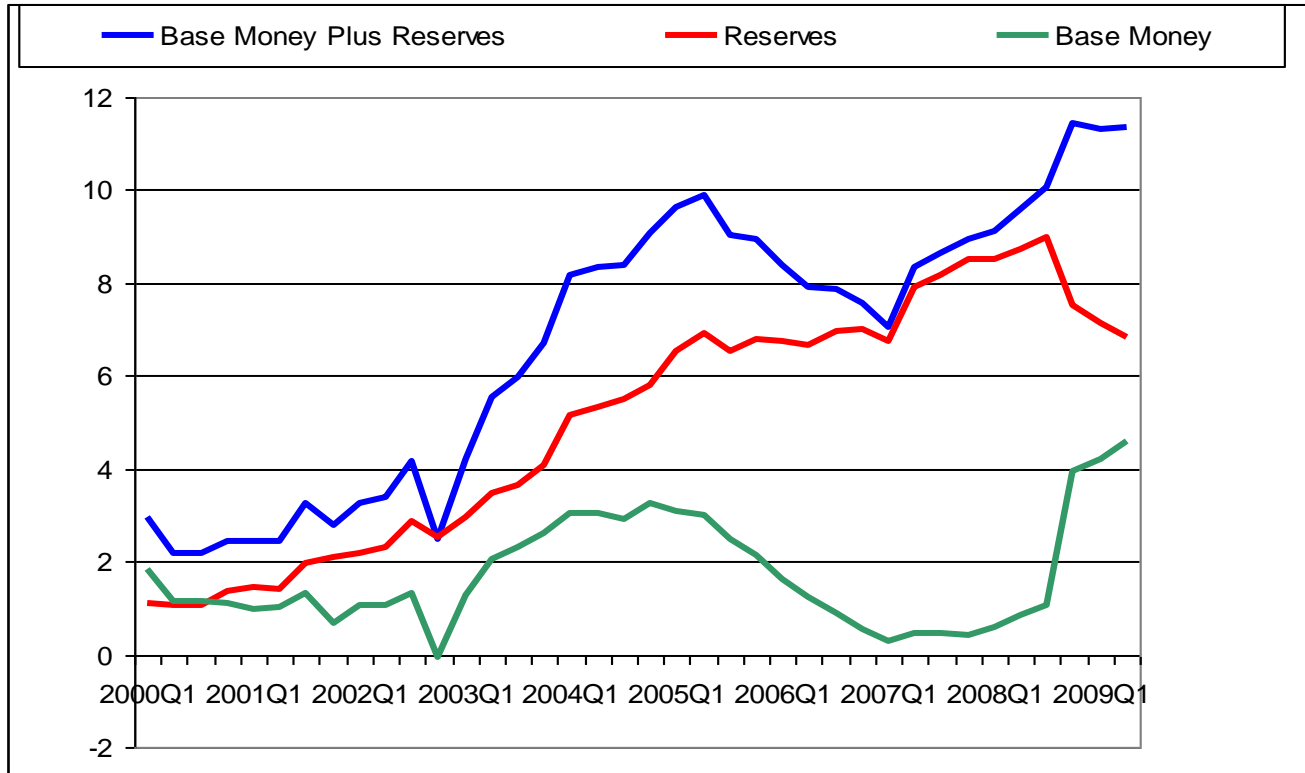


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... which is linked to the rise in global liquidity and risk appetite

Quantitative Liquidity Measures (percent of G3 GDP)



Sources: Bloomberg Financial Markets/ Eurostat/Haver Analytics/Merrill Lynch.

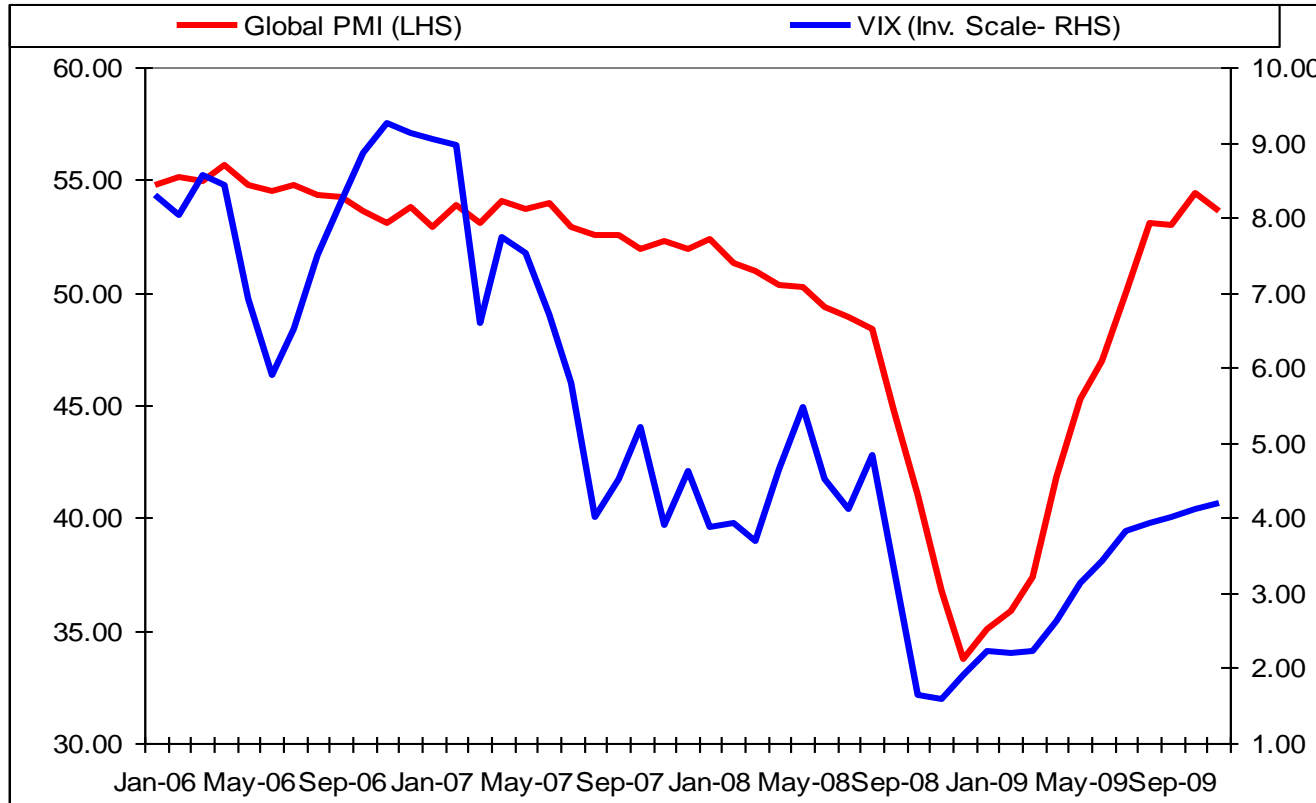


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# Synchronized growth brings a return to risk appetite

VIX and PMIs



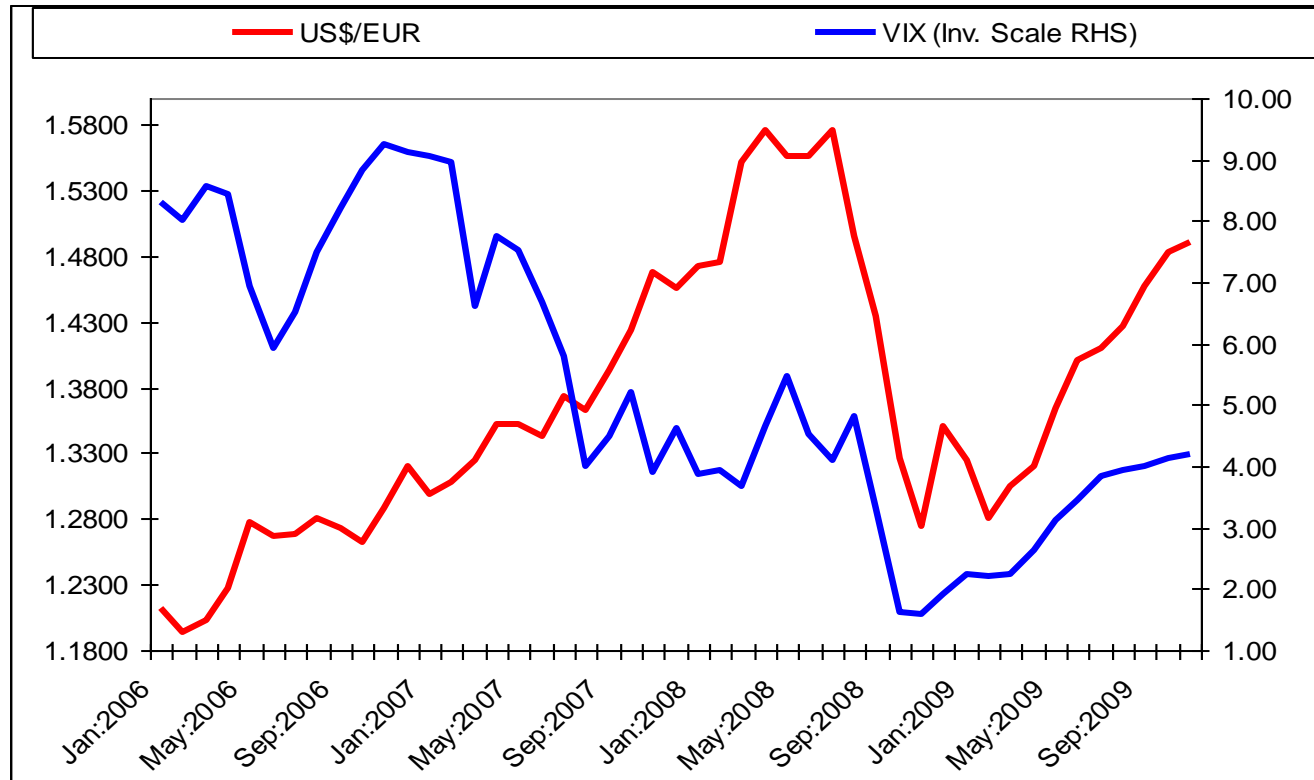
Source: WSJ; Markit/Haver Analytics



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# ... A positive for the Euro



Source: WSJ; Markit/Haver Analytics

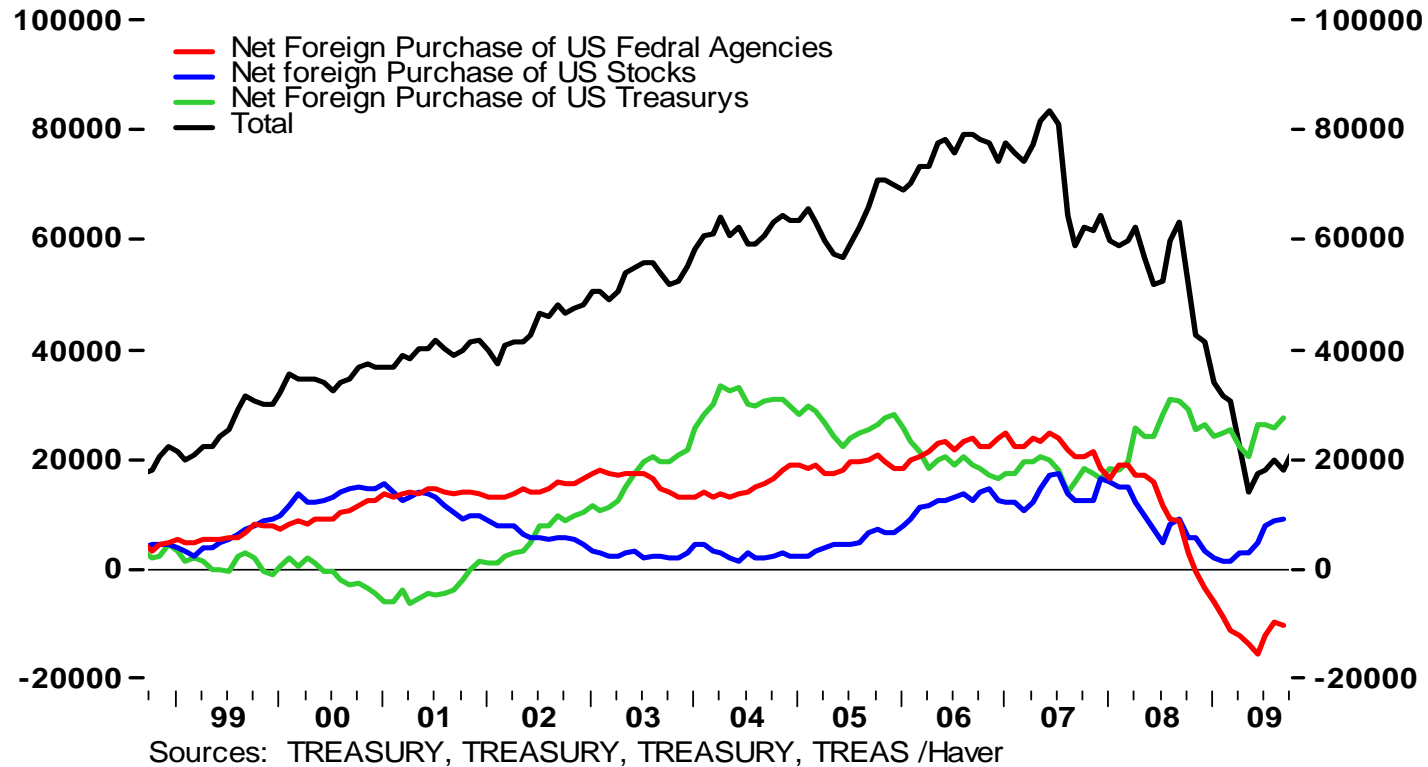


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# Foreign appetite for US assets has slowed

Net foreign purchases of US assets, 12-month moving average, \$ Mil.

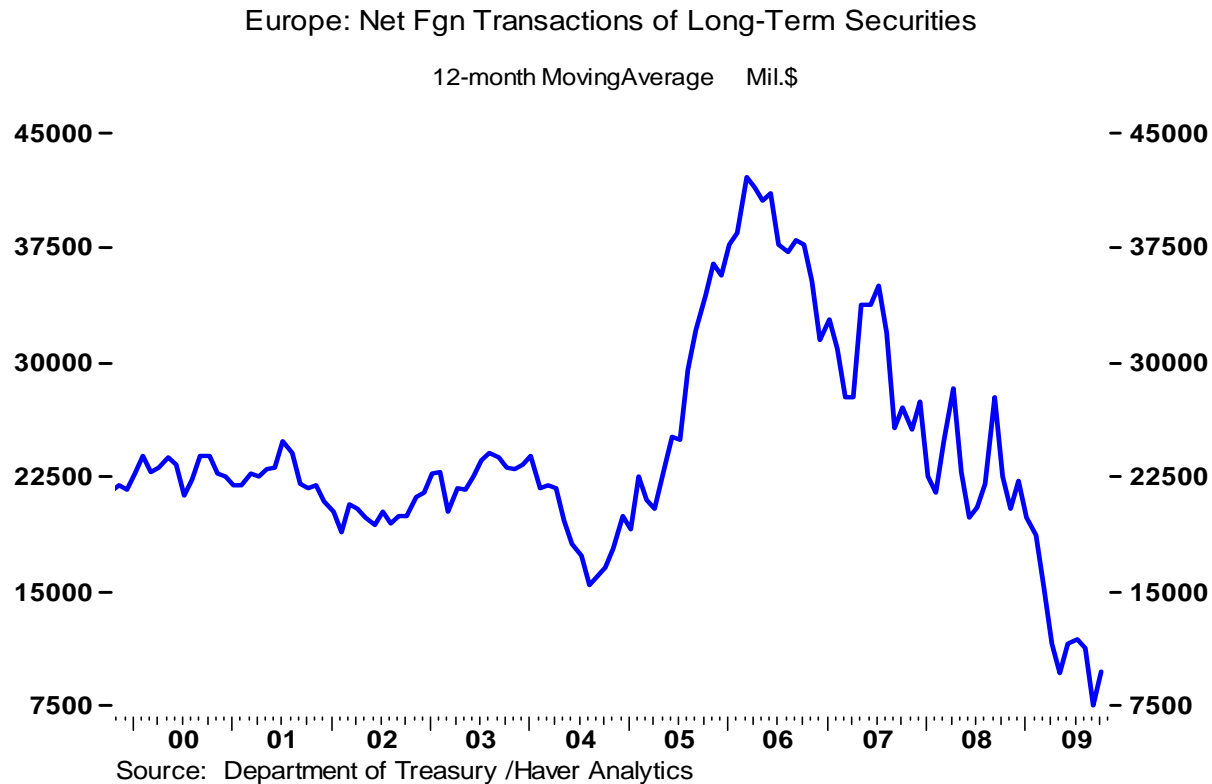


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# European appetite for US assets has slowed the most

Net European (including the UK) purchases of US assets, 12-month moving average, \$ Mil.



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# Negative Euro Factors

- Euro area growth differentials with the US;
- Euro area needs rebalancing of growth;
- Perceived Sovereign Risk fears.

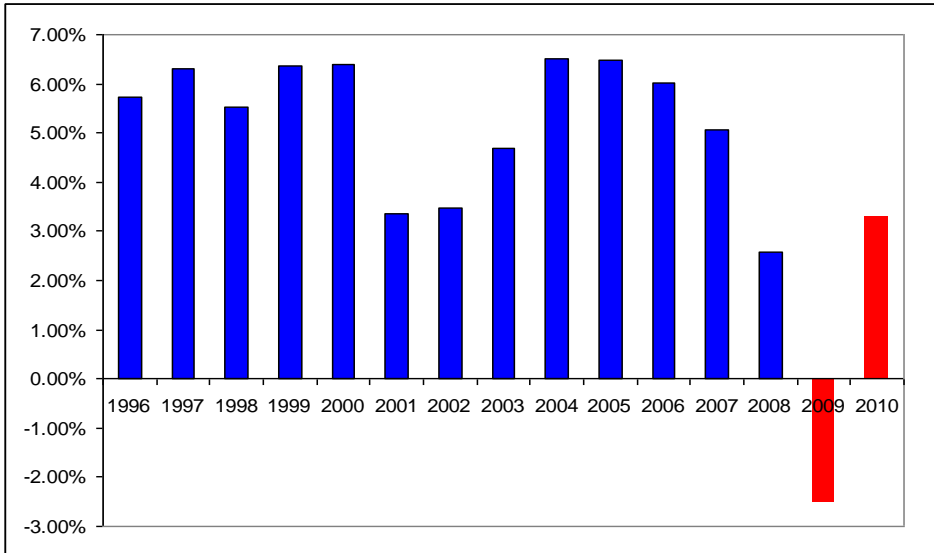


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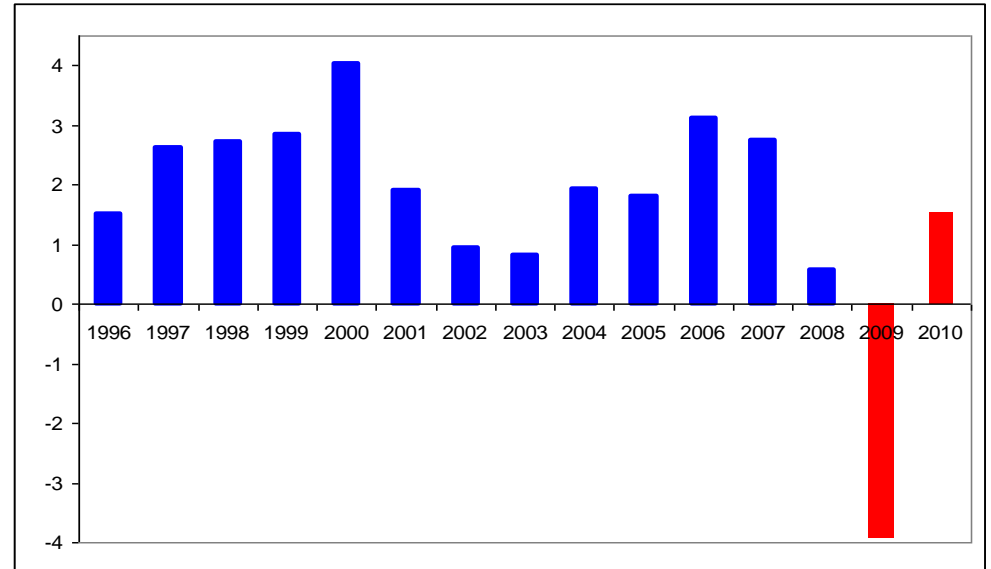
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# Growth differentials between the US and the Euro area favor the USD, replacing the risk aversion/USD relationship

US Real Gross Domestic Product (SAAR, Bil.Chn.2005\$) % Change - Annual Rate



Euro area Real Gross Domestic Product (Mil.Chn.00.Euros) % Change Y/Y



Note: Aladdin projections in Red

Sources: Bureau of Economic Analysis/Statistical Office of the European Communities/Haver Analytics

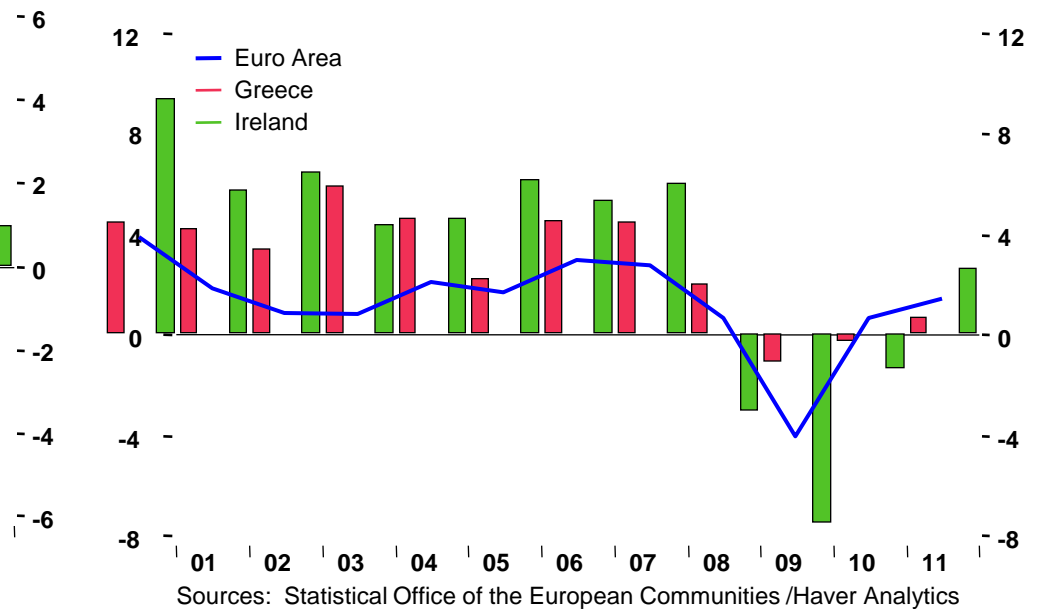
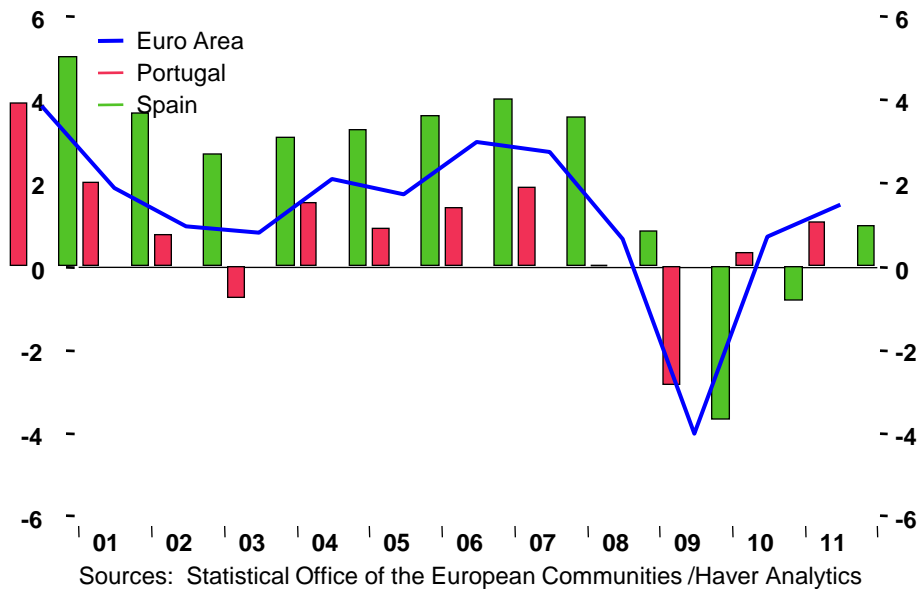


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# Collapse in growth in smaller countries

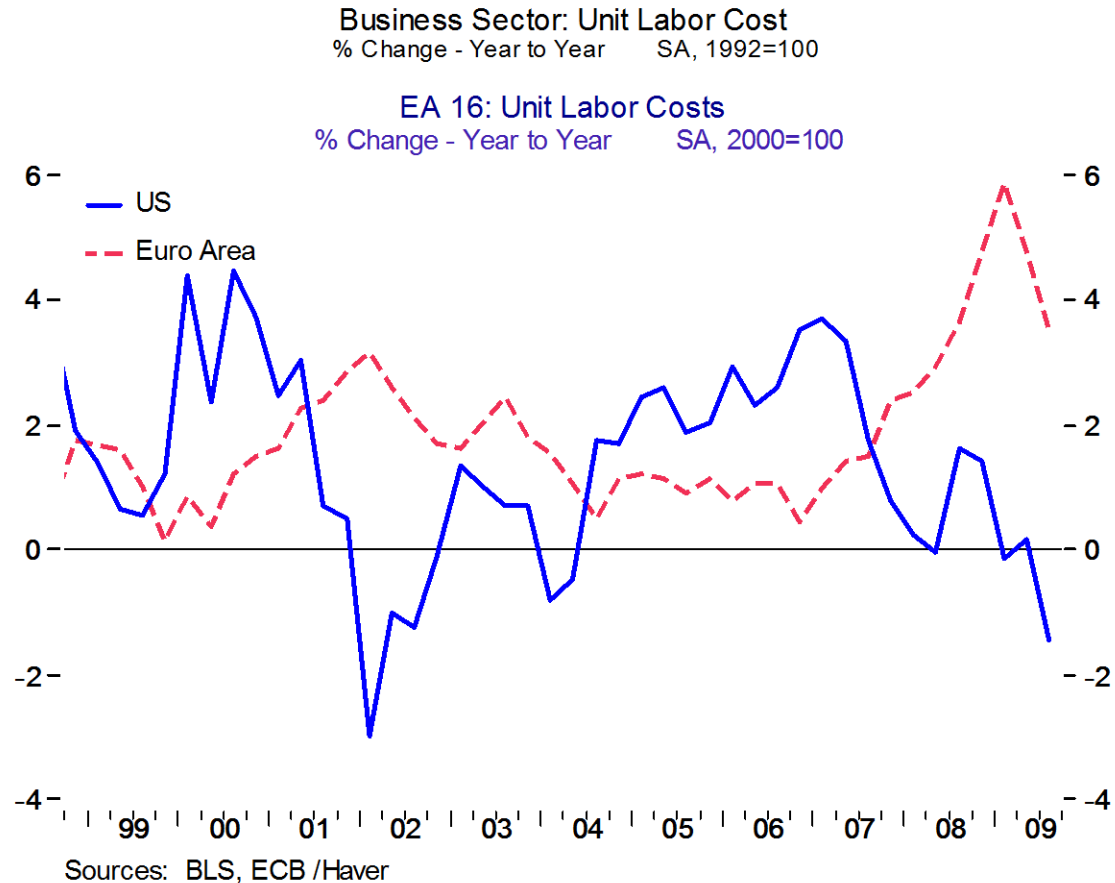
GDP year-on-year % change



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# Loss of competitiveness...

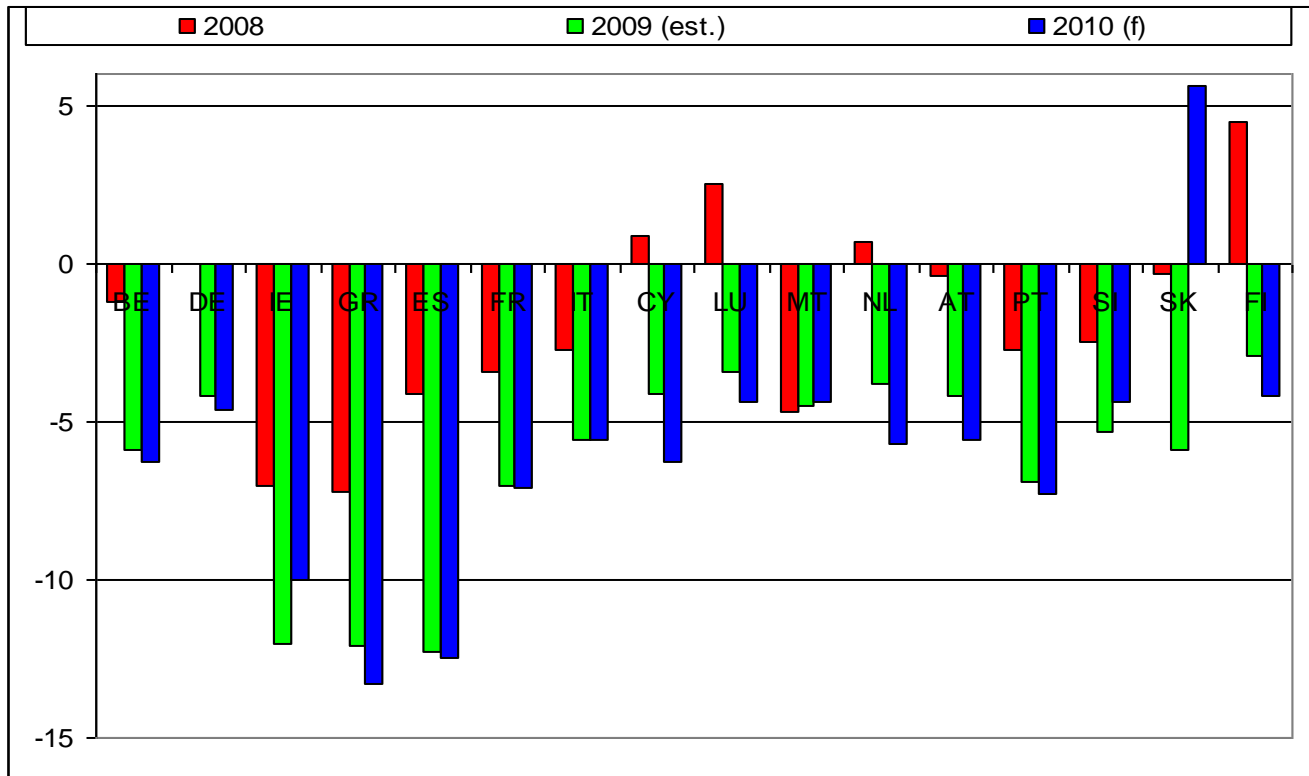


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# ...And deterioration in the Euro area fiscal outlook...

Euro area General Government Balance-to-GDP



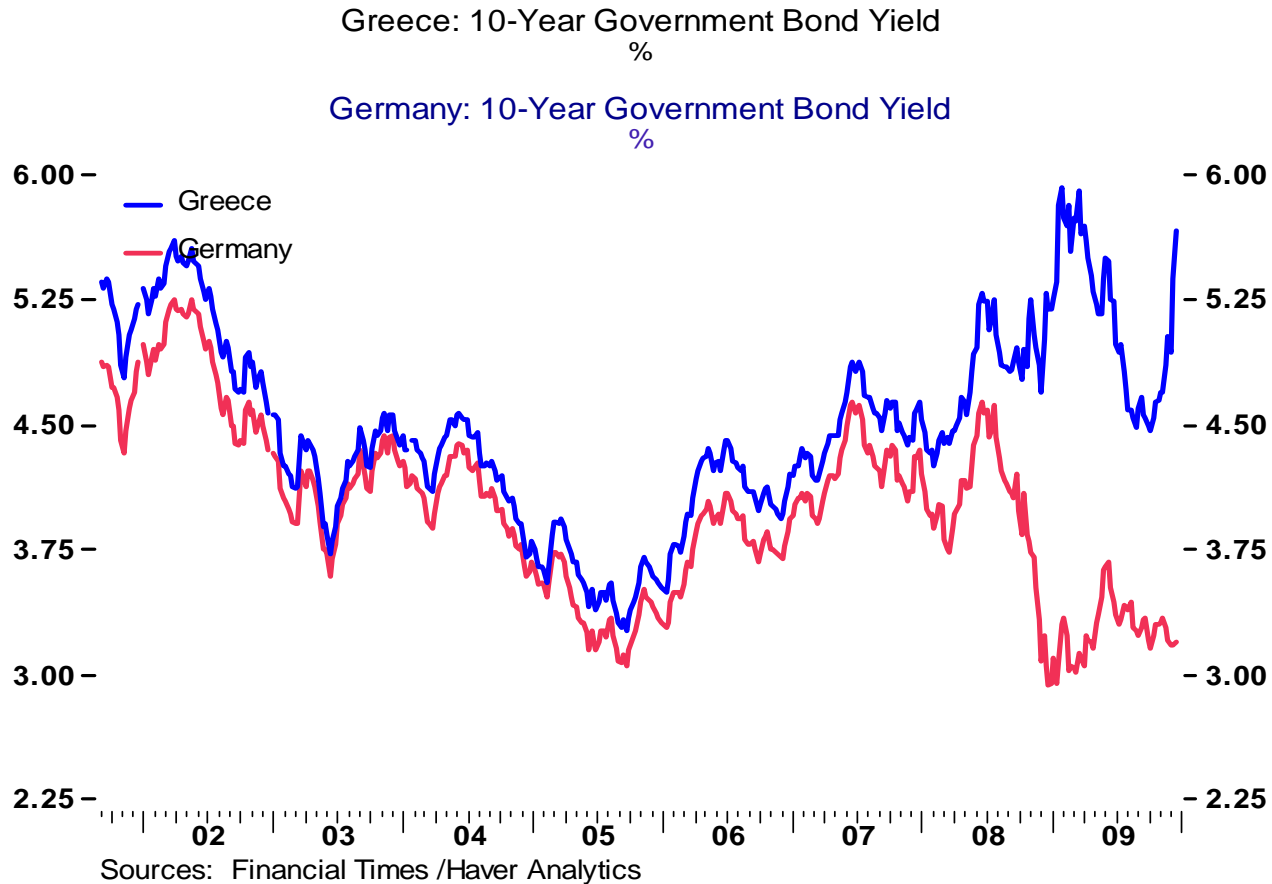
Sources: OECD/Haver Analytics



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... Have led to sovereign fears, a negative for the Euro

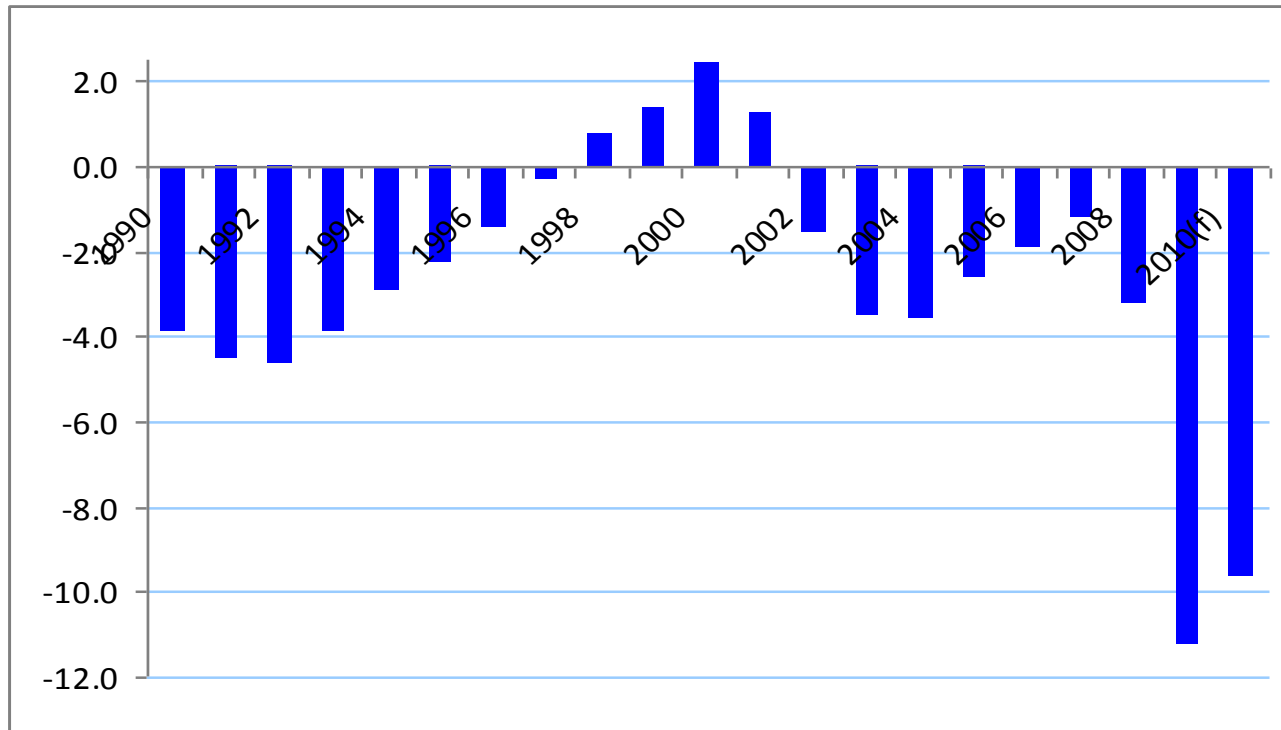


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# The fiscal situation has deteriorated in the US as well, dampening the negative effect on the Euro/USD

Budget deficits (-)/surpluses (+) by fiscal year (as a percentage of gross domestic product)



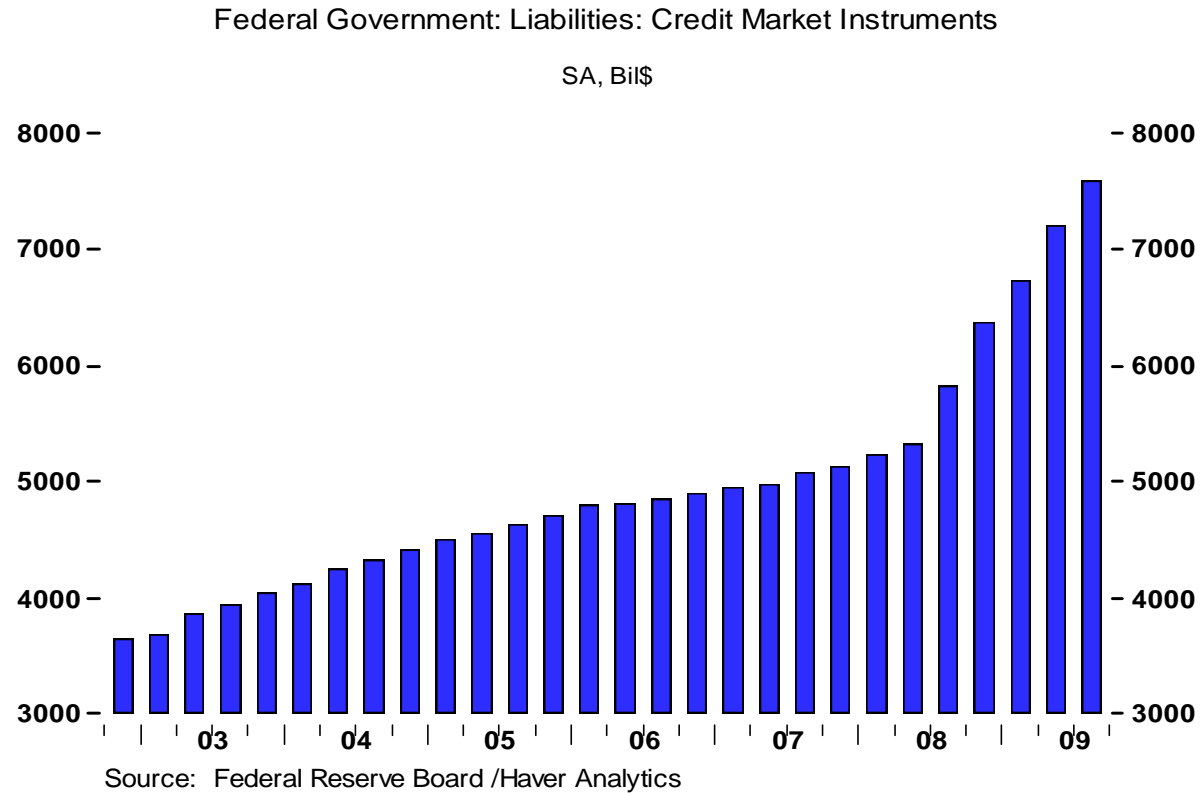
Source: Congressional Budget Office



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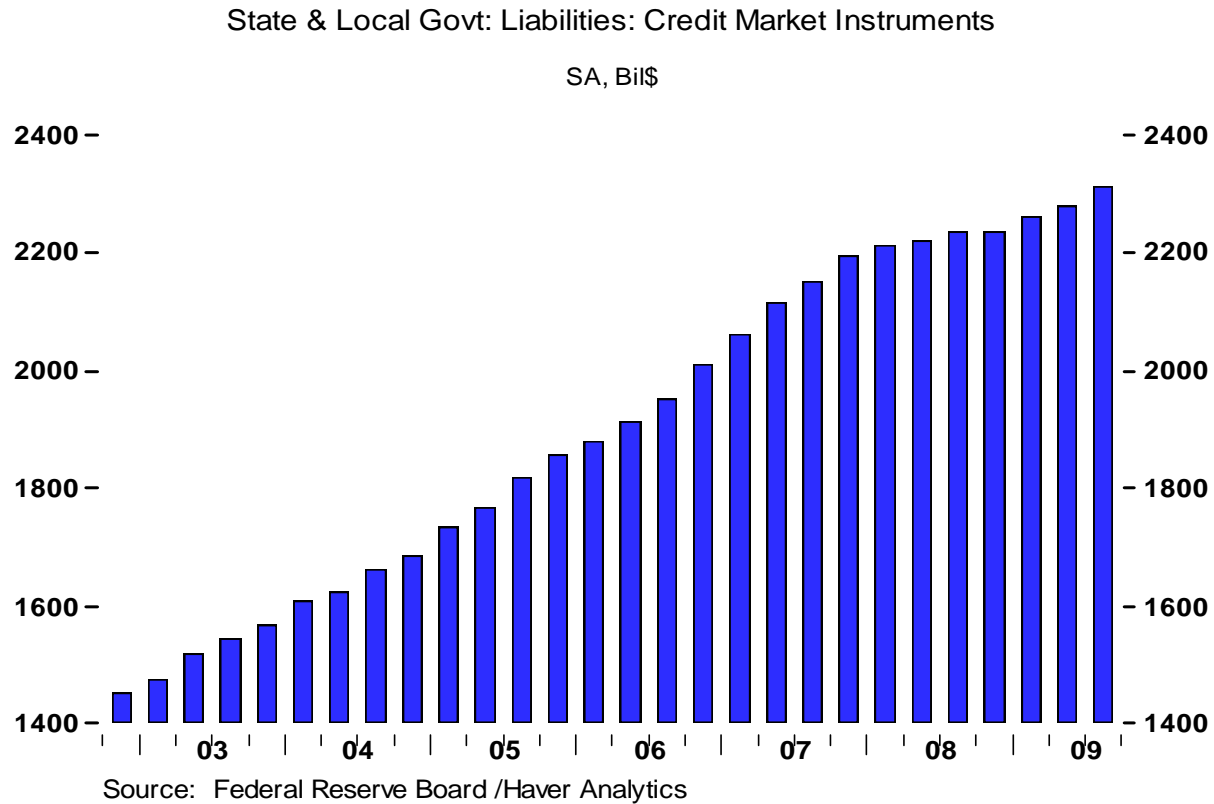
... With the accumulation of debt at both the Federal



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# ... And State and Local Government Levels



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# Historical Perspective

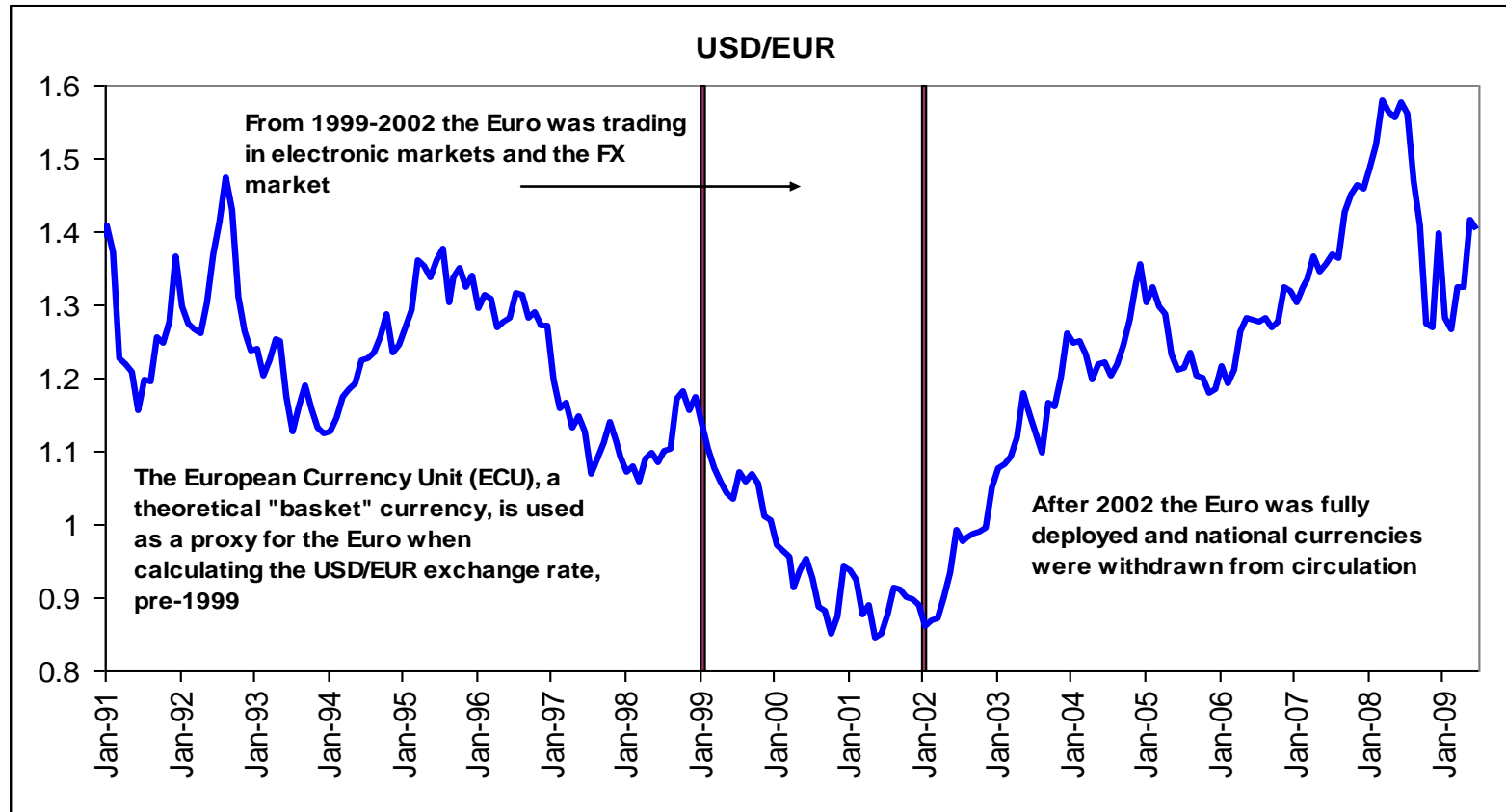
- The success story



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# Euro declines rapidly against the USD, then rebounds strongly



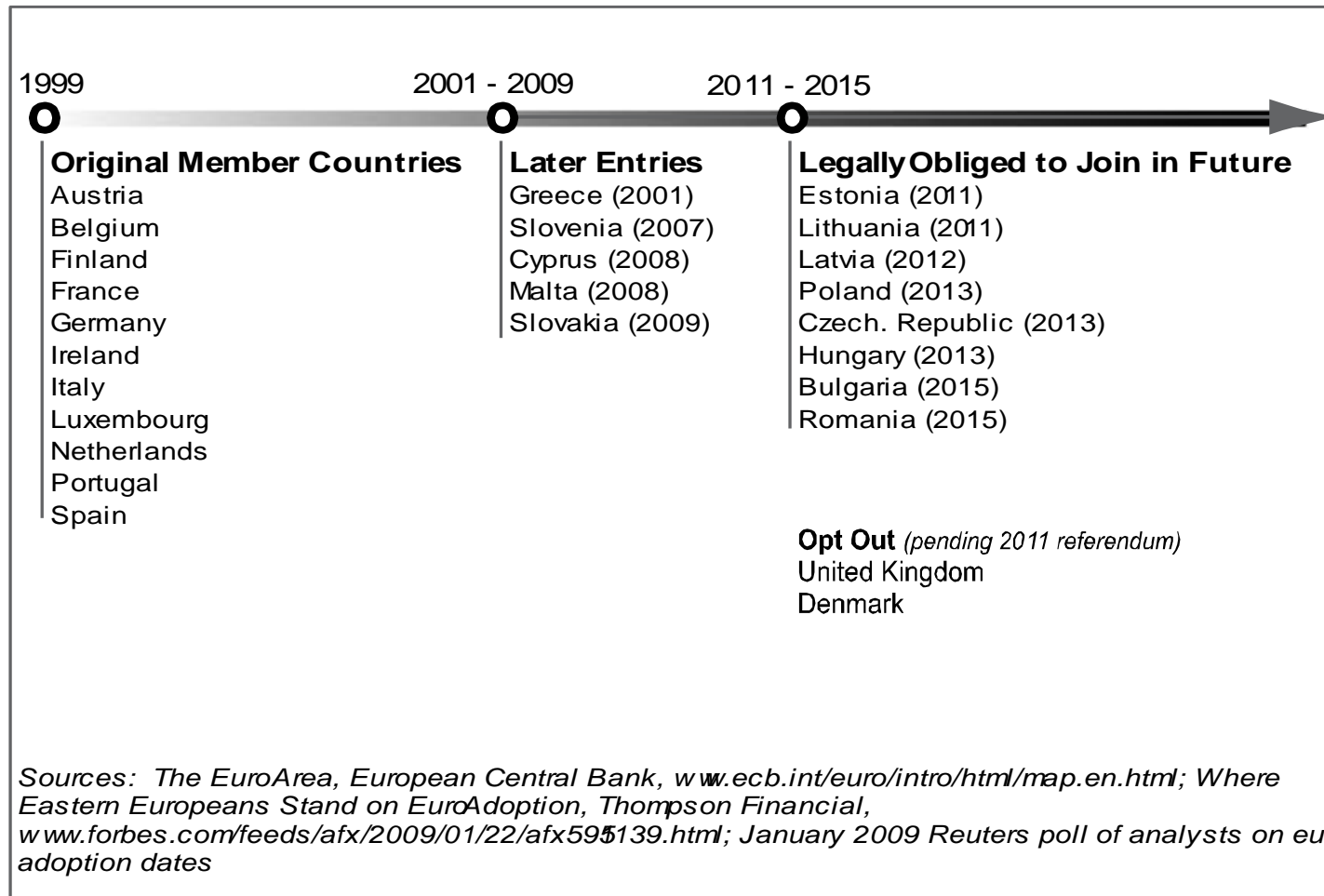
Sources: Bloomberg/Cumberland Advisors



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# The Euro's success measured by its rapid expansion: After ten years, 11 became 16

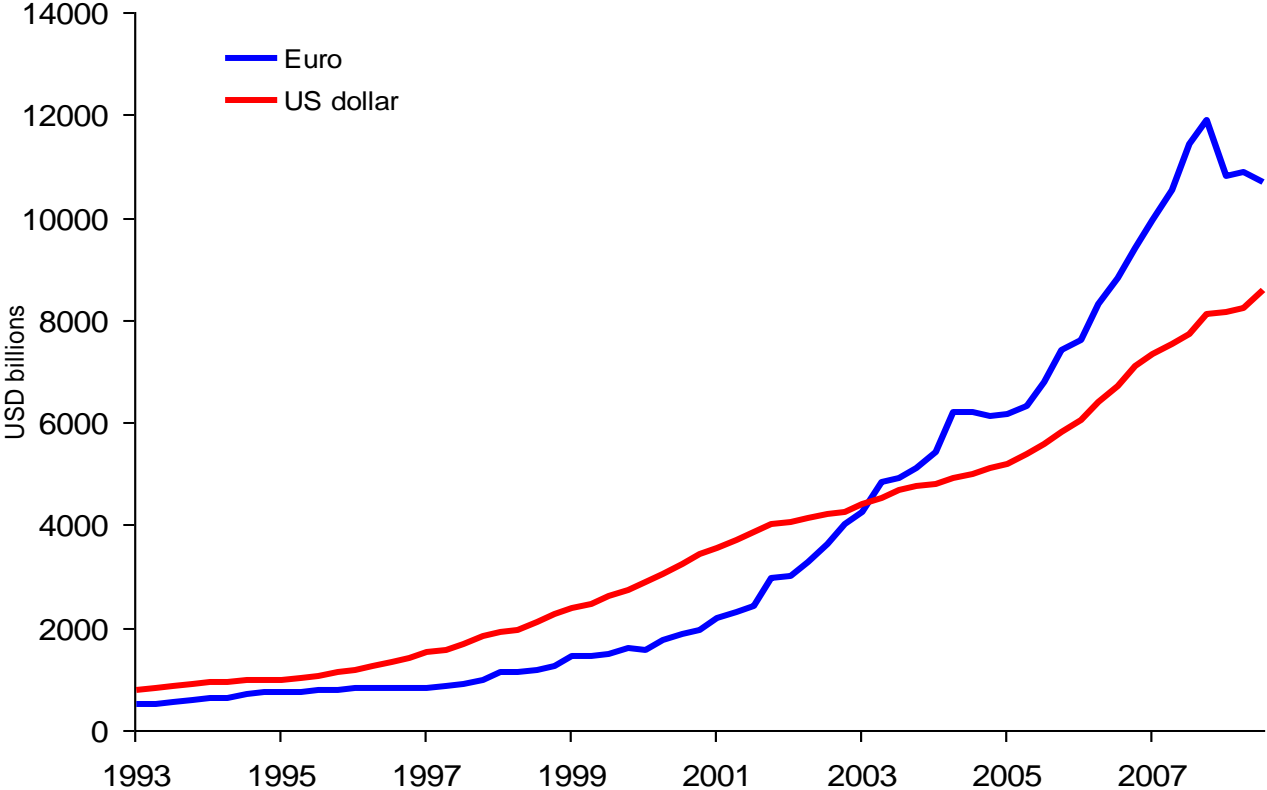


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# International debt issued in Euros and USD is roughly equal

Amounts outstanding of international bonds and notes, by type, sector and currency (in billions of US dollars)



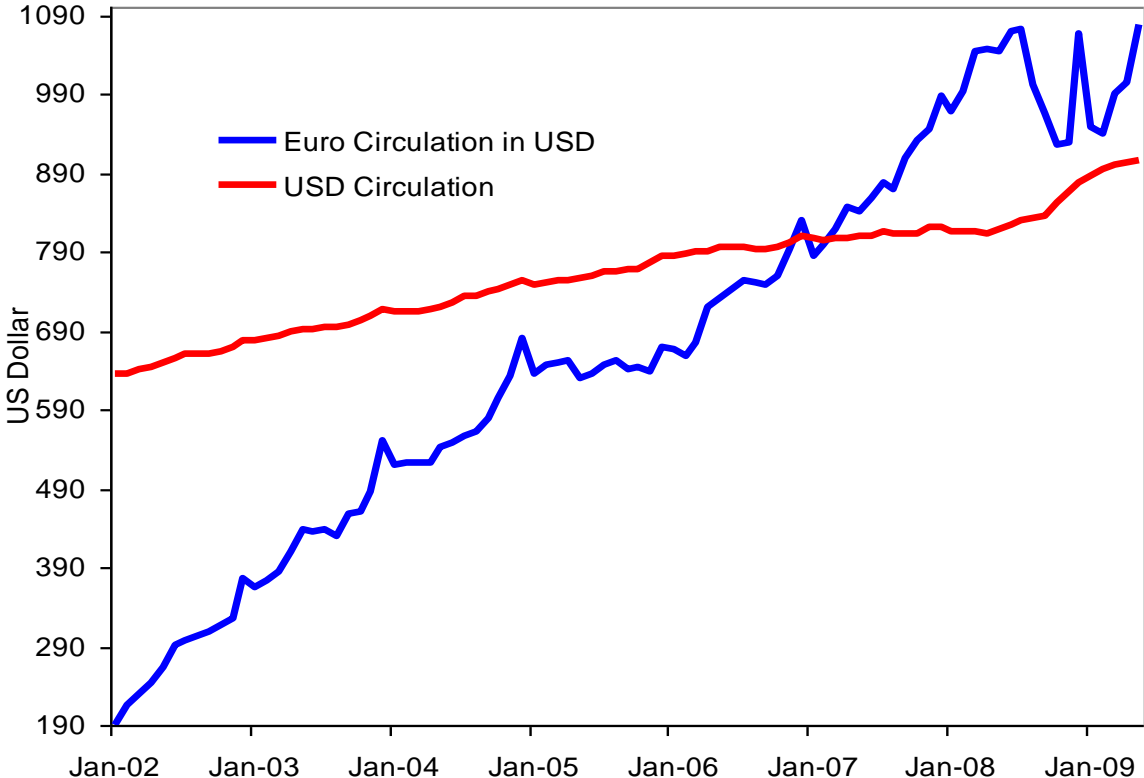
Sources: BIS Quarterly Review: 'June 2009



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# Global cash outstanding in Euros Is Greater than in USD



Note: Euro area (changing composition) - Net Circulation - number of banknotes/coins in circulation (for banknotes it has to be calculated, and equals created notes less destroyed notes less stocks of the NCB) - Banknotes - All denominations - 1st design - Stock - denominated in Euro. Sources: Federal Reserve Bank of St. Louis, European Central Bank, and Cumberland Advisors



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