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Growing Case For Sharp Correction in the Euro

*Based on a March 11, 2015
client bulletin.

- **Euro area profits to continue improving at least through the first quarter**
- **The euro may well rise in the next month or two against most major currencies**

The euro has fallen 24% against the dollar over the past year (chart 1), at least partially in anticipation of the ramp-up in ECB bond purchases beginning this week. However, a confluence of forces may well cause yields to rise and the common currency to rally in coming months. First-quarter euro area corporate profits and economic growth will probably beat expectations, pushing up both the euro and euro area bond yields; deflationary pressures could also stabilize, putting further upward pressure on yields. Higher bond yields and a strengthening euro would, in turn, make the carry trade still less attractive and thus provide an additional fillip to the euro.

Already there is an abundance of evidence that euro area data have outperformed expectations. The Citi Economic Surprise Index indicates that euro area data releases surprised on the upside throughout February as they had earlier in the winter.

However, this outperformance is not surprising from the Profits Perspective, as we first explained in our January 8 client bulletin and again in our February 3 bulletin, when we wrote:

Economic data from the euro area are likely to perk up for the next couple of months, possibly longer, thanks to the large boost to profits from lower oil prices and the depreciation of the euro. A number of European indicators have already firmed. We expect fourth- and first-quarter economic data from the euro area to generally beat or come in at the high end of expectations. QE may end up garnering much of the credit for any improvement in the European economy even though the program just started.

Several data releases over the past month that reflect improvement in the eurozone include the following.

- **A wider trade surplus in December** (chart 2). The weaker euro and the decline in the euro area's bill for imported petroleum bolstered the trade surplus—and thus profits—in the fourth quarter and have been boosting it further in

The Euro Has Fallen By Nearly a Quarter CHART 1

Federal Reserve: Dollars per Euro
end of period, last data point March 2015 (as of March 11, 2015)



Euro Area Trade Balance Has Surged CHART 2

Eurostat: Euro Area Goods Trade Balance
€ billions, seasonally adjusted, last data point December 2014



the first quarter. While the boost from cheaper petroleum imports may top out in the present quarter, lagged effects of the weaker euro will take several more months to fully affect the eurozone trade balance.

- **Solid rise in retail sales.** January's report showed a strong rise in nonfood, nonfuel sales (chart 3), suggesting that consumers are spending a good portion of their energy savings on other goods and services.
- **Strength in industrial production.** The three-month average in industrial production turned up in the final two months of 2014 (chart 4), and manufacturing PMI reports suggest growth continued in the first two months of 2015. Within the PMI release, several member states noted acceleration in export orders, consistent with our forecast for stronger eurozone exports. Production will probably continue growing through the first half of 2015, reflecting the improvement in profits, sales, and overall business conditions.

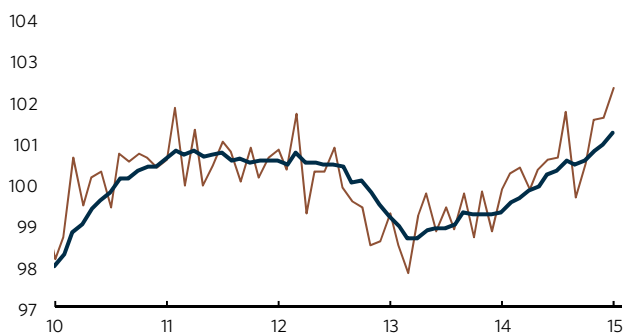
- **Multiple-month surge in capital goods orders.** Although the 3-month average of German capital goods orders from the euro area has recently flattened, the trend is still up strongly over the past six months (chart 5). The persistence of this uptrend indicates improvement in eurozone equipment demand that is more than a statistical quirk. Euro area fixed investment could rise through the end of the first quarter and into the second quarter. Although the pickup in euro area capital spending will in all probability be no more than a modest and brief cyclical phenomenon, it is likely to contribute to brightening the eurozone's economic performance for a few months.

Long-Term Disappointment, Short-Term Improvement

Our long-term forecast for the euro area economy is unchanged: profits could continue to grow feebly but will disappoint full-year expectations, as they have in years prior. Euro area private sector balance sheets are still too large relative to the size of the economy (chart 6), which will limit private

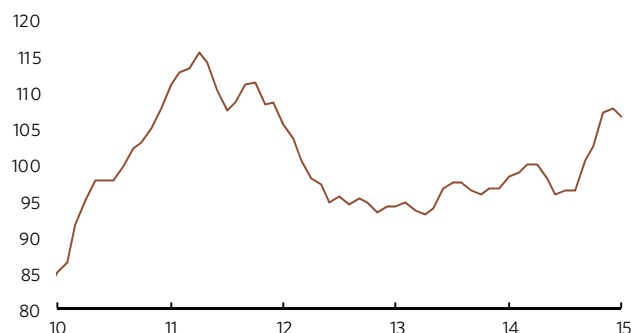
Retail Sales Trend is Accelerating CHART 3

Eurostat: Euro Area Nominal Nonfood, Nonfuel Retail Sales Index 2010 = 100, seas. adj., dark line is 6-month moving avg., last data point Jan. 2015



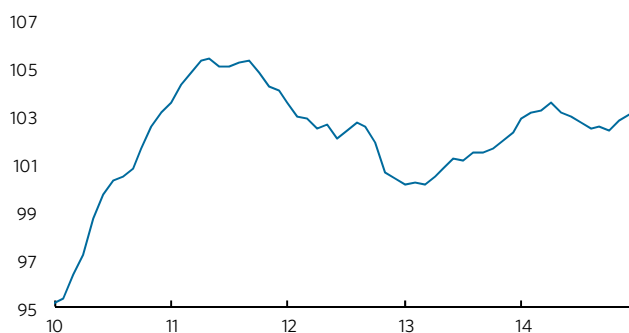
Strong Trend in Euro Area Capital Goods Orders CHART 5

Bundesbank: German Cap. Goods Orders from Euro Area, ex. large orders index, 2010 = 100, seasonally adj., 3-month moving average, last data point Jan. 2015



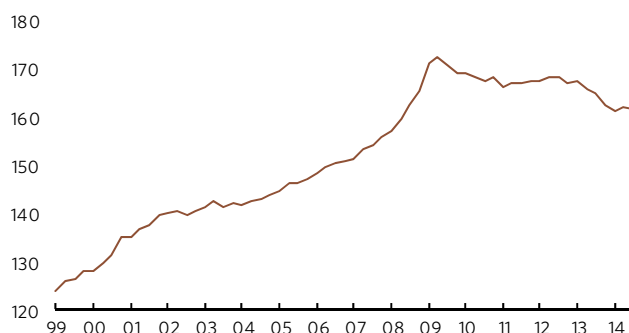
Nice Bounceback in Manufacturing Production CHART 4

Eurostat: Euro Area Manufacturing Industrial Production Index 2010 = 100, seasonally adj., 3-month moving avg., last data point December 2014



Still-Large Euro Area Balance Sheets CHART 6

Eurostat: Euro Area Private Nonfinancial Sector Debt as % of GDP last data point Q3 2014



domestic profit source growth. Meanwhile, the euro area's general policy of fiscal restraint—even if not the aggressive austerity of recent years—continues to prevent any significant profits injection from the public sector. An expansion in the euro area's current account balance has been the only notable and sustained contributor to profits over the last several quarters, and the surplus will probably begin to narrow in the second half as emerging market economies continue to deteriorate and as the euro area's bill for imported oil bottoms out.

For now, however, the current account surplus is benefitting from a cheaper euro and will probably widen further in the first quarter and possibly into the spring, further increasing profits, sales, and expectations for future growth. A trade-related improvement in euro area profits would also tend to reduce deflationary forces in the euro area (see our January 5, 2015 client bulletin, "Falling Oil Prices Do Not Worsen the Euro Area Deflation Threat"). Moreover, the decline in the euro is also forcing up non-petroleum import prices. Higher inflation in non-petroleum imports will serve to help offset broader deflationary forces.

A rise in profits and some easing of the perceived deflation threat could, in turn, push up bond yields and reverse the decline in the euro, barring major countervailing developments such as a serious worsening of the Greek crisis. On top of this, a stronger euro and higher bond yields would make the euro carry trade (borrowing in euro to lend in dollars) less attractive, reinforcing upward pressure on the euro.

Meanwhile, do not count on ECB bond buying to drive yields down further or even to keep them depressed. Consider that in the United States, QE *announcements* have triggered declines in Treasury yields, but the yields typically rose during *implementation*. The euro area bond rally, like the euro's decline, could be susceptible to a reversal.

The growing talk of euro-dollar parity and the swelling short positions in the euro combine to make the market ripe for correction. However, speculating on any rebound in the euro would be a relatively short-term play—in stark contrast to our call for *secular* U.S. dollar strength. For medium- and long-term strategies, the potential spurt in the euro is a move to be prepared for and defended against.



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