



## CIO Memo

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# Is the recent EUR/USD rally sustainable?

### Key take aways

- The EUR/USD recently breached its long-term 1.18 threshold in the wake of persistently strong price-momentum.
- Recent market movements suggest a repricing in the “Euro currency risk premium.” The new fiscal policies and improvement in virus case-loads appears to have set union on the right track to bolstering an economic recovery.
- With investor positioning now stretched, we should expect the currency pair to see some price reversion at current levels.

### 1. What happened?

The EUR/USD breached the 1.1830/1.1850 threshold, overcoming both a longer-term 12-year resistance level, as well as, the more recent September 2018 high. The currency pair has seen the Euro display persistently strong price-momentum relative to the USD following its 200-day SMA breach back in late May, in which, it has risen rapidly from its more consistently held 1.10 levels to the levels seen today. Furthermore, this momentum has resulted in aggressive investor positioning for the Euro, with swap dealers reporting a 50% increase in net-long positioning over the past 12-months.

### 2. How did markets react?

It is clear now that some of the traditional medium-term drivers of FX pricing (such as interest rate differentials) are not entirely at play here since we have also seen the U.S. Fed now following the same path of other major central banks in slashing its benchmark rate. Instead, we believe that markets have begun to price out “Euro currency risk premiums” as the union appears to be forming constructive policies to help bolster economic growth. This is to say that the recent fiscal stimulus package, along with the Eurozone’s ability to effectively manage their virus caseload, has set the region on a better relative path to recovery following the COVID-19 crisis. We can observe this when analyzing the negative attribution impacts on the broader USD Index (DXY), which has been primarily driven by the strength of the Euro (its largest cross-currency weighting).

### 3. What does it mean for investors?

We would also be remiss to not highlight that there are some broader, more structural disadvantages building for USD. Markets have recently begun to price in higher inflation expectations following the passing of the multi-trillion dollar fiscal stimulus. This has resulted in the 5-year, 5-year Forward Inflation Expectation Rate to steadily double from its March nadir of 0.83% to the 1.67% level today. Meanwhile, real yields, as measured by the 10-year TIPS rate, have reached a record low of -0.95%, reflecting a more lackluster recovery than what equity markets have so far been pricing in. Markets are also taking note on what investors should expect in 2021 and beyond, with the U.S. Elections now favoring a Democratic victory that could ultimately lead to even higher fiscal spending and budget deficits. Furthermore, expectations for additional QE and other non-traditional monetary measures are likely to provide USD headwinds. These drivers have also led some investors to ditch their greenbacks for alternative safe-haven plays, such as Gold, which is up almost 30% year-to-date. So where does this leave the EUR/USD going forward?

Overall, the strength in the EUR/USD cross has been impressive, but the current trajectory leaves us to question its sustainability. We believe that momentum is now stretched, and the aggressive positioning that is net-long could reverse after the end of this month (following the rebalancing flows that will adjust for the increase in the US stock market, leading to more USD sell orders). Therefore, we would expect some price reversion at the current levels.



## Glossary

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An **overnight index swap (OIS)** is an interest rate swap where the periodic floating payment is generally based on a return calculated from a daily compound interest investment.

A **mortgage-backed security (MBS)** is a type of asset backed security which is secured by a mortgage or collection of mortgages.

**Libor** or **London Inter-bank Offered Rate** is an interest-rate average calculated from estimates submitted by the leading banks in London.

**GDP** or **Gross domestic products** is a monetary measure of the market value of all the final goods and services produced in a specific time period, often annually.

**Purchasing manager indices (PMI)** provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

**SAAR** or **Seasonally adjusted annual rate** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total.

The **S&P 500** is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

The **Fed** and **Federal Reserve System** is the central banking system of the United States of America.



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