Stock Market Review

Euro strength or US dollar weakness?

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The value of a currency is always quoted in terms of how much it can acquire of another currency. Therefore, movements in exchange rates are a reflection of the strength or weakness in one currency relative to another.

Recently, the euro touched an eight-month high against the US dollar at 1.36. One can debate at length whether this is attributable to euro strength stemming from the eurozone economy or weakness in the US dollar connected to political bickering in the US over budget issues and the debt ceiling.

This week's article is intended to shed some light on the events that have impacted the US and the EU in recent years, the response of policy-makers, the outlook for both economies and the impact on their currencies.

Both the US and the eurozone economies passed through a severe recession in the aftermath of the 2008 financial crisis. However, the response of policymakers in each jurisdiction was different. Since the first signs of economic difficulties back in 2007 (these were initially related to the deteriorating US mortgage market but eventually spread to a banking crisis which in turn adversely impacted overall economic activity), the US Federal Reserve embarked on aggressive monetary policy measures which included the reduction of its benchmark interest rate (referred to as the Federal Funds Rate) from 5.25 per cent in August 2007 to a historically low rate of between zero per cent and 0.25 per cent by June 2011. In a further bid to prop up the US economy, the US Federal Reserve injected a total of $2.25 trillion between December 2008 and the second quarter of 2011, through what is referred to as the quantitative easing programmes.

The actions of the European Central Bank (ECB), although also unprecedented for the 17-nation bloc, were implemented in a more staggered fashion. In fact, the ECB took six years to reduce its official rate from 4.25 per cent in July 2007 to its record low 0.5 per cent in May 2013. In contrast, the US Federal Reserve took four years to aggressively reduce its interest rate. Other actions by the ECB included two covered bond purchase programmes totalling €100 billion (although this has not been fully utilised to date) and subsequently, the ECB injected liquidity into the region's banks through more than €1 trillion of three-year loans at low rates (referred to as Long-Term Refinancing Operations). This was split into two tranches with the first launched in December 2011 and the second in February 2012.

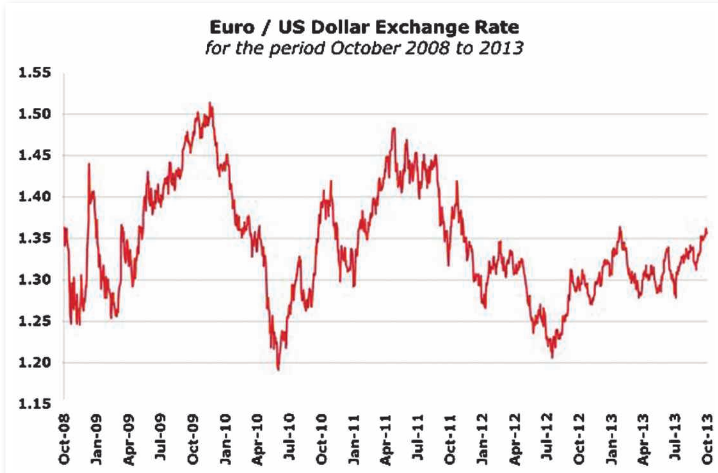
Despite the more aggressive monetary policy easing of the US Federal Reserve, the euro weakened to near six-year lows of $1.20 by July 2012 from its all-time high of just above the $1.60 level in July 2008 as the eurozone was evidently witnessing a weaker economic recovery since the global recession. Various economies across the 17-nation EU bloc were struggling as the recovery was partly being hindered by the significant austerity measures in some countries. These had been introduced to counteract their huge sovereign debt piles. Portugal, Ireland and Greece, additionally required a bailout, while Spain and Italy were on the brink of requesting international assistance as their economies continued to contract.

In late 2012, the US Federal Reserve embarked on its third quantitative easing programme as it believed that the recovery in the US economy was not strong enough. The US Federal Reserve launched an open ended commitment to buy $85 billion monthly of mortgage backed securities and long-term treasuries. Meanwhile, the ECB did not feel the need to inject further liquidity but supported the eurozone's sovereign bond markets with the unveiling of its Outright Monetary Transactions (OMT). This initiative was mainly targeted at the sovereign bonds of Spain and Italy as their respective yields were rising to unsustainable levels. However, the programme was never activated as markets were satisfied with the ECB's promise in July 2012 to "do whatever it takes to preserve the euro". This statement by ECB president Mario Draghi was a fundamental turning point for the euro and together with the increased supply of US dollars, this helped the euro to strengthen and the USD to weaken to a value of $1.36 by early February 2013.

Shortly afterwards, markets started factoring in the possibility of a reduction in the stimulus measures by the US Federal Reserve. This was later substantiated by comments from chairman Ben Bernanke that the US Federal Reserve was planning to start tapering its $85 billion monthly asset purchase programme by the end of 2013 and completely close it by mid-2014. Meanwhile, the ECB pledged to maintain its expansionary monetary policy stance for some time to come. In fact, on various occasions Draghi explained that the bank has various instruments at its disposal which it can use to support the eurozone economy including a further interest rate cut and a new Long-Term Refinancing Operation (to inject liquidity into banks if necessary). Furthermore, the instability of the eurozone was again in focus as Italy struggled to form a coalition Government after no political party emerged victorious in the February 2013 general elections. All this prompted markets to shun the euro in favour of the US dollar with the exchange rate drifting back to the $1.28 level by early July 2013.

Since then, the euro/US Dollar exchange rate recovered largely reflecting the differing political developments in both regions. In the eurozone, markets welcomed the re-election of Angela Merkel as Chancellor of Germany for the third time while Italy managed to form a coalition Government which has somewhat managed to survive many obstacles including last week's confidence vote in Prime Minister Enrico Letta. More importantly, Italy and Spain continued to raise their borrowing requirements from the market while also managing to reduce their spread over the benchmark German Bund yields. In fact, yields in Italy and Spain slipped closer to the four per cent level from as high as 7.5 per cent for Italy (November 2011) and 7.7 per cent for Spain (July 2012) indicating improved confidence across the markets.

In the meantime, on the other side of the Atlantic, the US Government was in partial shutdown for the first time since 1996 as the US Congress failed to reach a deal on a new Budget by October 1, 2013. Apart from the adverse impact on the US economy from such events, markets are also presently concerned that this political deadlock will be repeated in respect of the required raising of the US debt ceiling, currently at $16.7 trillion. Agreement on this must be reached by October 17. Failure to reach an agreement in this respect could severely hinder the US Government's ability to meet its obligations. Furthermore, the brief period of strengthening in the US dollar seen in the run up to the September US Federal Reserve monetary policy meeting was short-lived



after the US central bank surprisingly announced that it has postponed the start of the tapering of its asset purchase program. The US Federal Reserve is now expected to begin reducing its stimulus measures by the end of 2013.

The recent political developments in the US led to a further weakness in the USD to $1.3645 on October 3, 2013. However, notwithstanding the recent euro strength versus the US dollar, the euro is still significantly below its all-time high of just over $1.60 reached in July 2008. This reflects the weaker and more fragile economic profile of the eurozone region when compared to that of the US. Additionally, there are various political issues the European community needs to iron out over the coming years especially at the European Union level in order to achieve the ultimate objective of a more harmonised union. In fact, GDP growth in the eurozone is still lagging behind that of the US and unemployment levels across the 17-nation bloc are still significantly higher than in North America especially in the 'Under 25' category.

Furthermore, the weakness in the USD in recent weeks as a result of the nervousness in the market related to the partial US Government shutdown and the debt ceiling should start being reversed once the US Congress reaches a compromise agreement on its fiscal Budget and the debt ceiling.

Data published over recent weeks and months indicates that the US economy is in a fundamentally stronger position than that of the eurozone and this is also evident from the actions of the respective central banks.

While the US Federal Reserve remains more inclined to start tapering its asset purchase program, the ECB is maintaining a dovish stance and is expected to protect the eurozone from a strengthening currency which could damage the region's exports and in turn hamper its recovery.

As such, recent exchange rate movements between the euro and the US dollar can be more attributable to temporary weakness in the US rather than a fundamental strengthening of the euro.

Wide exchange rate fluctuations can have significant implications on the performance of investment portfolios and investors should therefore closely monitor developments and re-consider whether such foreign exchange exposures, which carry additional risk, are adequate or warranted in view of their overall investment objectives.