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## Euro Developments: De-Stressed But Still Uncertain

The EUR/USD has soared over 1400 pips from its June low of 1.1877 and the pair has since maintained its rally, breaking above the 1.320-figure. Since then the pair has been trading at around the 1.310-levels. In fact, about two months ago, many were calling for EUR/USD towards 1.100 (or even parity), and we were also looking at around 1.1800 by the end of this year (which is a tad higher from our PPP fair-value of 1.130).

The rally can be explained in part by incoming weak US fundamental news that we have witnessed of late and a related decline in US yields relative to Europe. An uneventful European bank stress test has also helped pave the way for the 16-nation currency. Sovereign CDS continues to narrow as European credit concerns continue to dissipate amongst signs that vulnerable countries are successfully implementing their fiscal adjustment plans and better-than-expected European economic indicators.

While the stress test is behind us now, and the situation in the PIGS countries appear to be stabilising, macro-economic risk remains. The US economic recovery, especially on the job market front, remains challenging. As the market contemplates with the implication of the 'unusally uncertain' phrase, it looks like the Fed could remain on hold for a much longer period. So, what do all these mean for EUR/USD outlook in the days ahead?

### Stress Tests Well Received

The Committee of European Banking Supervisors (CEBS) released its summary report on the results of the EU-wide stress test exercise on 23 July, showing that only 7 out of the 91 institutions had failed to meet the Tier One capital ratio of at least 6%; with a EUR3.5bn capital shortfall among the 7 failed institutions - well below the EUR30bn-figure touted by some market participants.

As a matter of fact, markets had gone into the tests expecting the "adverse" scenario assumption will not be too rigorous. However, in terms of transparency and disclosures, it was certainly a big leap forward. And whilst these tests may have raised more questions than answers, the results appeared to have calmed fears surrounding the European banking system. Hence, it was a good start, as we can probably say with a certain degree of confidence, that many of the big financial institutions are well-capitalised and liquid, with their access to wholesale funding not impaired.

### The ECB Versus The "Unusually Uncertain" Fed

Spread compression in the key Treasury/Bund yield gap has been greater than before, led in part by reserve flows from core, back into peripheral Eurozone bonds as the ECB's bond buying program has helped stabilise the latter; along with the expiration of the ECB's 1-year EUR442bn without needing to be fully replaced by shorter term ECB funding operations. PIG countries bond auctions have been generally well received as well. This increasing spread (which was negative in June) has helped buoyed the Euro, becoming a much more significant factor for the currency's price action over the past month. Recent comments by the IMF mission chief for Greece that structural reforms in Greece are ahead of schedule and its labour market and pension reforms "comprehensive" has allayed fears of Greece not meeting its fiscal targets as part of the IMF-EU bailout program in May.

Furthermore, signs that the recovery is sustaining in the Eurozone have raised the outlook for tightening from the ECB while a weak labour market in the US has simultaneously sunk hopes of a Fed rate hike. Of course, the situation is not helped by the recent dour comments by Fed Chairman Bernanke, which he has described as still in quite a weak

condition and even highlighted the possibility of needing loose monetary policy until we see gains in jobs. More recently, there have also been suggestions in the WSJ (and elsewhere) that the Fed might decide to use the cash it receives when its mortgage-bond holdings mature to buy new mortgage or Treasury bonds, instead of allowing its portfolio to shrink gradually (as it had been expected to do in the months ahead).

Given the outcome of yesterday's FOMC statement and its decision to purchase long-term Treasury securities to support the economy; along with the rather gloomy US employment situation, low medium-term inflation risk and slow pace of economic activity, the delay in hiking the rates to 2H11 seem plausible. We are now factoring-in a 25 bps Fed hike towards the end of 3Q11. Over in Europe, the ECB is also unlikely to move until 2011 given the continued weak economic outlook against the backdrop of fiscal measures being undertaken, coupled with continuing sovereign debt problems; though likely that it may move even before the Fed does.

### Judging The Beauty Pageant Between The Eurozone And The US

Of late, numbers rolling out from the US confirm a significant cooling in the pace of expansion for the world's largest economy:

- The first estimate of US GDP growth for Q2 was modestly weaker than expected, with growth coming in at 2.4% saar. Perhaps of more concern was the modest 1.3% saar growth in final sales.

- More recently, the US employment report for July showed the private payrolls number coming in at +71K, compared to expectations of a rise to +90K from June's revised 31K. The headline non-farm payrolls number of -131K, was down from -221K in June compared to consensus expectations of -65K. Separately, the unemployment rate remained static at 9.5% on consensus expectations of a rise to 9.6%.

- And the latest weekly initial jobless claims numbers continue to disappoint, seen popping to 479k (the highest reading since 10 April) for the week ending 31 July, higher than the consensus expectations of 455K.

- The personal income and spending report for June also pointed to a loss of momentum late in the quarter, where both numbers – though unchanged in June – had come in a little weaker than markets were expecting.

- Another disturbing one was the pending home sales report, which showed a further 2.6% m/m decline in June after the stunning 29.9% decline seen in May.

- Falling levels of confidence does not bode well for the near term either; and this stagnation is largely a product of an entrenched level of high unemployment, which in turn will see consumer spending (accounting for approximately 70% of output in the US) and in turn, the economy itself stalling.

In contrary, we have been receiving a raft of better-than-expected economic reports from the European space, and these economic data surprises have swung sharply in favour of the Euro.

- Consistent with the advance PMIs and German IFO, the EC's economic sentiment index rose a greater than forecast 2.3pts to 101.3, which is the highest reading since March 2008.

- The run of especially encouraging data continued in Germany as well, with unemployment down another 20K in July, dropping the unemployment rate to 7.6%.

- We also noted a solid 3.2% m/m rise in Germany factory orders in June, largely thanks to a 5.7% m/m rise in foreign orders. Orders for capital goods were up 6.4% m/m.

- ECB President Trichet had also sounded more upbeat on the Eurozone economy. At his press conference, he highlighted that available Q3 economic data is better than expected and that money markets are slowly improving. Whilst "growth is likely to remain uneven and relatively modest", the risks to the economic and inflation outlook are "broadly balanced".

## EUR/USD Ending Note

The moves in both equity and fixed income markets over the last couple of months have certainly excited speculation in the dollar's path, which undoubtedly, is growing more difficult to decipher. While financial risks are behind us, the economic implication is still working through. When looking at the EUR/USD, the outlook is clearly mixed.

From a risk perspective, the need for a US dollar safe-haven continues to diminish. Unless we see fresh evidence that the Eurozone has decoupled from the US economic slowdown currently in train (which looks unlikely now), we think that the EUR/USD should remain supported for now. In fact, the pair has been holding up quite well after breaching the 1.320-figure on 3 Aug, with the 1.325-target now being discussed. In our view, the pushback of expectations of the Fed's tightening will help those who look for prices to stay above 1.300, and we can see perhaps, one more upside squeeze, which could reach to as high as 1.350.

Nevertheless, our view is that gains in the EUR/USD look fairly restricted and the overall downward trend in the pair remains largely intact, with bids likely at successive levels down to about 1.280. After all, we are in an environment where it is not just the US that is seeing growth wilt. The European debt crisis may have faded for now, but problems have been merely postponed not eliminated by the May rescue deal. Repercussions from it will be felt in the next few years, with broader structural issues needing to be addressed across swathes of the Eurozone. Besides, the promises of sharp austerity measures have dimmed the medium-long term growth outlook for the region.

Taking into account the above factors, our baseline scenario is for the EUR/USD pair to remain supported at current levels over the next quarter or so before declining. We are looking for the pair to trade around the 1.330-levels by the end of 3Q and consequently moving lower to a year-end target of about 1.310. The ranges we are looking at are shown in Table 1.

**Table 1: EUR/USD Forecast**

| | Current | 2010 | | 2011 | |
|---|---|---|---|---|---|
| | | Q3 f | Q4 f | Q1 f | Q2 f |
| **EUR/USD** | 1.304 | 1.330 | 1.310 | 1.300 | 1.280 |

*Source: UOB*

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