

Euro...Has It Reached Its Trough Or Is It Still In Its Throes?

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- So, how low will EUR stretch? Besides the mess in Greece (and broader EU), our take is that the extended EUR weakness is part of an economic adjustment process, monetary policy in per se, to cushion the lack of fiscal flexibility.
- In this note, we have provided a few approaches to fair-value of the single currency (NEER as well as PPP) – although such calculations may not be totally useful in tail-event situation. Based on historical NEER, fair-value is around 1.1980, and 1.130 on PPP terms. We are also looking at CBs' holding of EUR as part of FX reserves management.
- Overall, we expect EUR/USD to reach 1.220 by end-2Q10 and then towards 1.180 by end-2010. Our assumption assumes no departure or any sort of default from Greece. Otherwise, a collapse in confidence could result in EUR towards 1.100 or lower.

EUR has fallen more than 5% against the dollar this month, and is about 12% lower for the year, making it the worst-performing major currency to date. Over the last six months or so, the single currency has already dropped more than 2000 pips from its high in 2009. And now the 16-nation single currency sits on the verge of tipping into territories not plunged in four years despite the entire clamour about bailouts and restoring stability to Europe. German Chancellor Angela Merkel had said midweek that the euro was in danger. She had called for a radical overhaul of Europe's fiscal rules along German lines, warning of "incalculable consequences" for the European Union if the euro were to fail.

So, how low will EUR stretch? Besides the mess in Greece (and broader EU), our take is that the extended EUR weakness is part of an adjustment process, actually monetary policy, to cushion the lack of fiscal flexibility. In fact, participants are using the EUR to hedge against their EU exposures given the lack of hedging tools in the sovereign space.

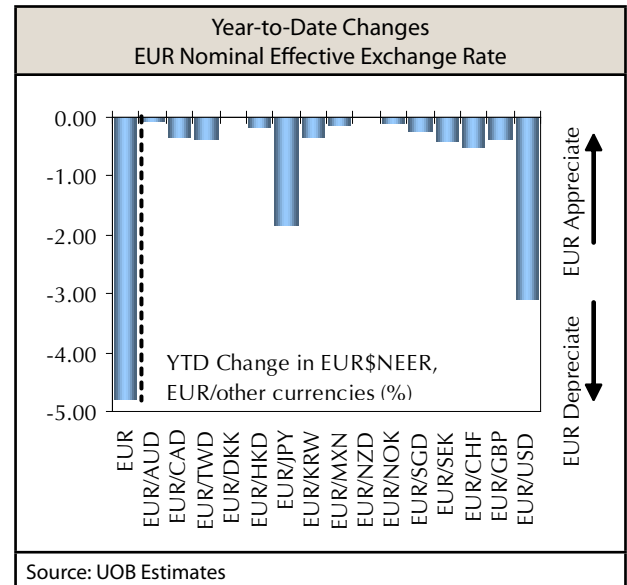
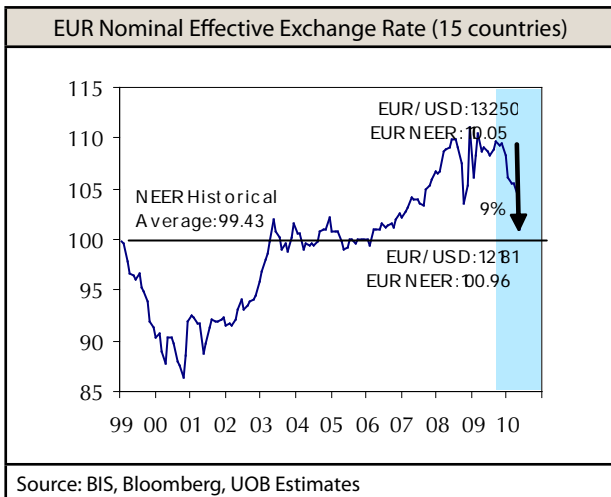
In this note, we have provided a few approaches to fair-value of the single currency (NEER as well as PPP) – although such calculations may not be totally useful in tail-event situation. Based on historical NEER, fair-value is around 1.198, and 1.130 on PPP terms. We are also looking at CBs' holding of EUR as part of FX reserves management.

Overall, we expect EUR/USD to reach 1.220 by end-2Q10 and then towards 1.180 by end-2010. Our assumption assumes no departure or any sort of default from Greece. Otherwise, a collapse in confidence could result in EUR towards 1.100 or lower.

Fair Value of EUR: Trade-Weighted Relative to History

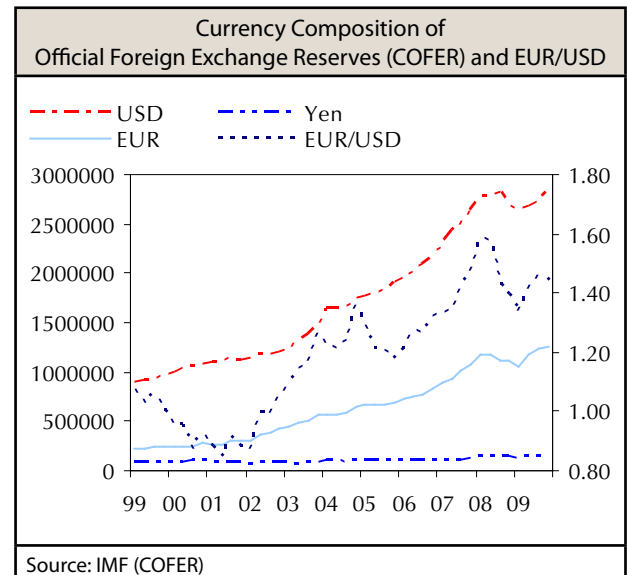
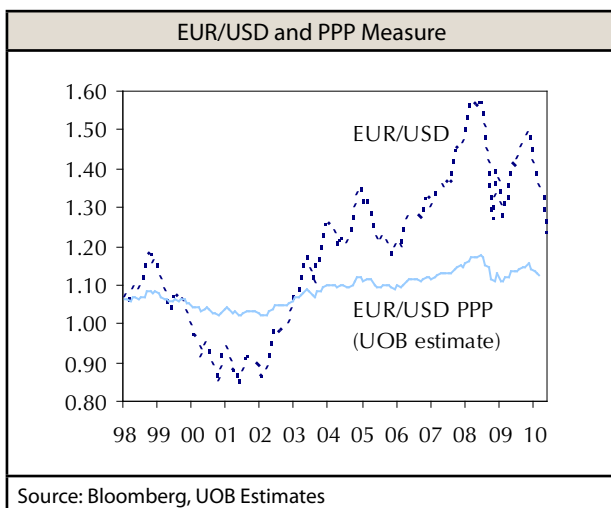
If we compare the trade weighted euro, as at 19 May, to its historical average, the trade weighted euro is 1.5% overvalued relative to its 11-year average. **This implies that to reach the NEER historical levels, the EUR/USD will need to settle at around 1.198.** This provides some evidence that the euro has not become too cheap at current levels on a trade-weighted basis. On a trade-weighted basis the euro has fallen by 9% from its peak in Sep 2009 (year-to-date around

4.8%) amid EU sovereign risk concerns. This is the sharpest decline in the EUR since its inception in 1999. It had previously fallen by around 13% but this was spread out for two years between 1999 and Sep 2000. The euro has fallen against the USD and JPY by about 3.0% and 1.8% respectively within the basket of currencies. Against the SGD, EUR has a fallen by around 0.2%.



PPP Approach: Fair-Value at 1.130

Our long term purchasing power parity (PPP) measure shows that the current levels of the euro still remain over-valued. The PPP measure captures the relative competitive difference between EU and the US. It provides a simple fair value of the EUR/USD based on inflation levels in tradable and non-tradables in US and EU. The average fair value of the EUR/USD which we view as possible floor for now is currently around 1.130.



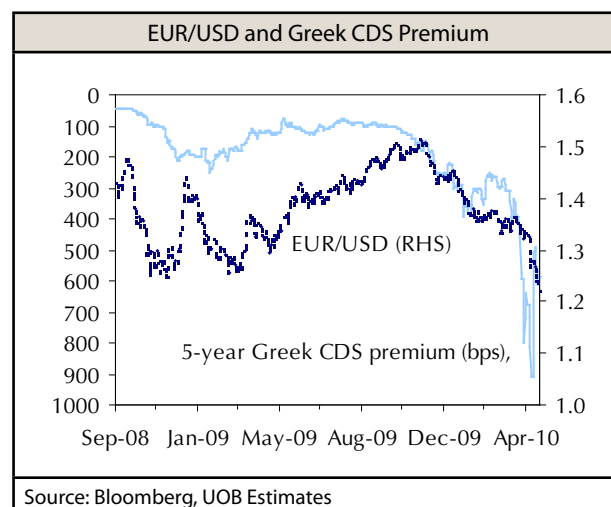
EUR: Still a Reserve Currency

A further look at the currency composition of official foreign reserves compiled by the IMF shows that global central banks have been accumulating around USD1trn worth of euros since 1999. It may be possible that the central banks may stop accumulating euros going forward given rising risk aversion but the proportion of euro holdings in the official sector is unlikely to fall drastically. This should ensure some certain downward stickiness on the EUR/USD.

Fiscal Risk Premium and Euro Downside Risk

Increased risk aversion as a result of further concerns about worsening EU sovereign debt problems may exacerbate further downside fiscal risk premium (event risk) on the euro. **Our internal estimates show that since the start of the Greek crisis, a 1% increase in the 5-year Greek CDS premium over bunds will lead to a decline in the EUR/USD by 0.0031%, ceteris paribus.**

The chart on the right provides further evidence of the positive relationship between EUR/USD and the proxy of EU sovereign risk (5-year Greek CDS premium). Further developments in the sovereign debt market, i.e. upcoming redemptions, peripheral fiscal measures, Greek reporting to IMF/EU in August and possible ratings downgrades – may have further impact on the EUR/USD, as negative sentiment continues to add to volatility. Notably, the recent restrictions on short-selling in selected EU bank stocks, credit default swaps and bonds may create further volatility in the foreign exchange markets as markets re-allocate their exposures.



On an Ending Note

Recent developments in the EU will continue to affect global investor confidence for months to come as the market continues to question how the EUR500bn package will unfold. Our baseline scenario is for the EUR/USD to decline further. We are looking for the pair to trade around 1.220 by the end of 2Q and consequently moving lower our year end target to about 1.180. These forecasts reflect our view that further downside risks remain for the EUR/USD as it remains subject to event shocks/risk, which could drive the single currency towards 1.100.

| EUR/USD Forecast | | | | |
|------------------|-------|-------|-------|-------|
| End-Period, 2010 | 1Q10 | 2Q10E | 3Q10F | 4Q10E |
| EUR/USD | 1.351 | 1.220 | 1.200 | 1.180 |
| Source: UOB | | | | |

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