

Eurozone Focus

Euro Troubled By Lingering Sovereign Debt Issues

UOB Economics Projections	2008	2009	2010F	2011F
GDP	0.5	-4.1	1.1	1.3
CPI, (average, y/y)	3.3	0.3	1.5	1.6
Unemployment rate (%)	7.6	9.4	10.1	9.8
Current account (% of GDP)	-5.1	-2.5	-0.2	0.1
Fiscal balance (% of GDP)	-2.0	-6.3	-6.9	-5.7

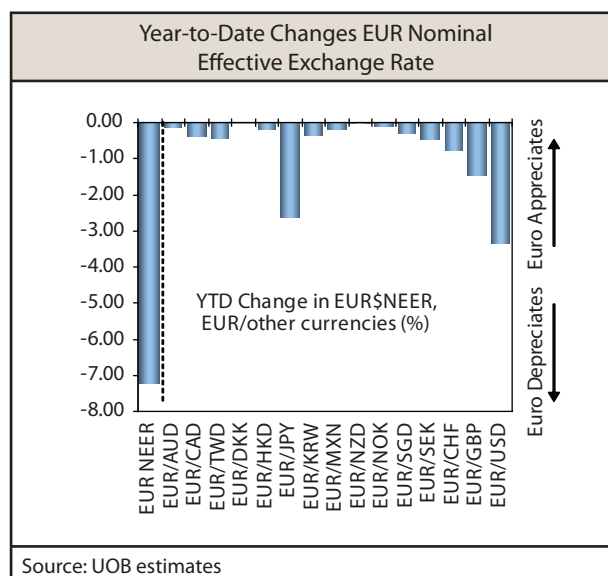
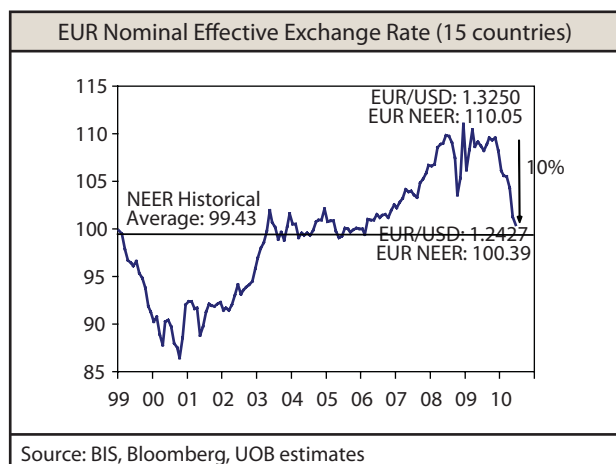
- Ongoing sovereign debt-related problems, banking risks and fiscal adjustments will continue to dominate EUR trading for the rest of the year.
- The single currency will continue to face further downside risks as it remains subject to event shocks/risk, and also part of policy adjustment process to cushion domestic troubles. Our end-year target for EUR/USD is at 1.19.
- Given, modest economic growth outlook, low domestic inflationary pressures and lingering sovereign debt risks, the ECB will probably be a laggard in hiking interest rates. We maintain our forecast for a rate hike only in 2Q 2011.

The eurozone sovereign debt issue dominated euro movements for most of 2Q 2010. Developments in Greece, the delayed response by the EU to Greece, inconsistent remarks by EU officials and concerns about spill-overs to other countries and financial markets continue to add downward pressure and volatility in the euro. Even after the EUR750bn IMF-EU bailout package and ECB measures in early May, the euro continued to fall amid concerns about Greece's ability to undertake its fiscal measures. Since the start of the year, the single currency has dropped more than 2000 pips from its high of around 1.45 in Jan 2010. The EUR/USD fell to a low of 1.19 in early June, and year-to-date was about 12% lower, making it the worst-performing major currency to date. It has since recovered to around 1.23 by 22 June as negative sentiment flows out of the eurozone dissipated in June.

Besides the developments in Greece (and broader EU), our take is that the extended EUR weakness over the past two quarters was part of an adjustment process, actually monetary policy, to cushion the lack of fiscal flexibility. In fact, participants are also using the EUR to hedge against their EU exposures given the lack of hedging tools in the sovereign space.

So, how far can the EUR be stretched on the downside?

We provide a few approaches to fair-value of the single currency (NEER as well as PPP) – although such calculations may not be totally useful in a tail-event situation. Based on



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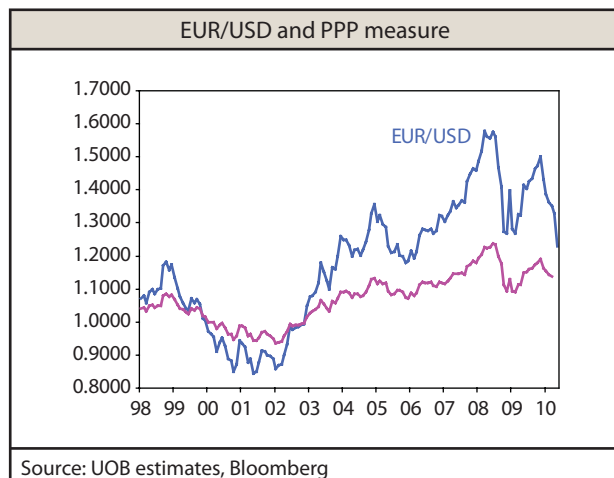
historical NEER, fair-value is around 1.20, and 1.13 on PPP terms. We are also looking at the central banks' holdings of EUR as part of FX reserves management helping to prop up the euro going forward. Overall, we expect EUR/USD towards 1.23 end-2Q10 and then 1.19 end-2010. Our assumption assumes no departure or any sort of default from Greece. Otherwise, a collapse in confidence could result in EUR towards 1.10 or lower. Also, if a Greek default eludes us over the next few quarters, then there may be some modest upside risk to our forecast given possible positive economic data out of the eurozone in 2H 2010.

Fair value of EUR – trade-weighted relative to history

If we compare the trade weighted euro, as at 21 June, to its historical average, the trade weighted euro is 1% 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 1.20.** 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 10% from its peak in Sep 2009 (year-to-date around 7%) 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 3.4% and 2.6% respectively within the basket of currencies since Dec 2009. Against the SGD, EUR has a fallen by around 0.3%.

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 overvalued. 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 USD1tn 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 Volatility

Risk aversion as a result of concerns about 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. Chart below 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 its volatility.

