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Euro a hero again? If not too weak or strong



David Bianco

Chief Investment Strategist, Americas
Deutsche Asset Management

Euro rallied on political relief, but interest rate differentials to cap upside

Relief of European political risks helped the euro rally against the dollar. But we think real interest rate differentials will cap euro upside well into 2018. EUR/USD has been in a \$1.05-\$1.15 range since early 2015. It's near the high end of that range now. We think it stays in this range and likely falls back toward the lower end as the Fed hikes further and yet the European Central Bank (ECB) likely waits longer.

Modest dollar strength vs. euro through 2018 FX markets have many complicated drivers, but interest rate differentials are powerful. Two more Fed hikes are expected in 2017 to raise the Fed Funds rate to ~1.4% at year end and then probably ~2% at 2018 end, and possibly higher in 2019 if unit labor costs accelerate. Yet, the ECB likely keeps overnight rates a bit under 0% through 2018 to help ensure Europe's recovery isn't derailed by exacerbated debt burdens from deflation or less competitive exports from a stronger euro. The political risks of such setbacks could threaten the currency union.

Different real rates justify spot FX divergence from PPP

Assuming US inflation near 2% and Europe a bit over 1%, this suggests a -1.5% real overnight interest rate in Europe vs. 0-0.5% positive rate in the US over the next couple of years. This real interest rate differential justifies a ~4% discount to the Euro's about \$1.15 purchasing power parity (PPP) today as that aligns future PPP after the differing real risk-free interest is earned. Thus, the Euro is likely to be usually just shy of \$1.10 through 2018. Real returns on other financial assets that the currencies give access to should also be considered like bonds and stocks, but those come with more uncertainty.

FX headwind to S&P EPS should be light

The DXY dollar index strengthened by ~17% vs. major currencies in 2015 vs. 2014. This caused a ~4% headwind to S&P earnings per share (EPS) growth in 2015. Every 10% stronger dollar vs. a basket of major currencies reduces S&P EPS by 2.5% or ~\$3.00. The DXY index stayed flat in 2016 vs. 2015 as the Fed didn't hike again until Dec 2016 after its initial Dec 2015 hike. We expect the DXY index to be up ~3% 2017 vs 2016 avg., and up ~3% again in 2018 (mostly on lower GBP, JPY). This is only a ~0.75% drag to annual S&P EPS growth.

Tech and other S&P multinationals benefit from fading FX headwind

Much weaker FX headwind will let good underlying growth at Tech and other multinationals shine through. Industrials benefit from less FX drag, but the sector is still challenged by weak commodity production related capex with valuations too dependent on a doubtful US public infrastructure spending boom, in our view. Thus, we favor European industrials instead, especially if the euro stays range bound. We expect S&P EPS to be \$131 & \$140 in 2017 & 2018, up 10.4% & 7% y/y respectively. Tech should lead with 11% & 9% EPS y/y growth in 2017 & 2018, assuming little or no FX headwind. Pharmaceuticals should also deliver mid to upper single-digit EPS growth.

A gradual rising dollar will help avoid sharp climb in long term yields

We'll keep close watch on how the dollar, 10yr Treasury yields and oil react to Fed hikes. The dollar likely continues to strengthen modestly upon further hikes. This will help contain labor inflation risk, which reduces the risk of the Fed having to hike rates higher in 2019 or a sharp climb in long-term treasury yields, which would pressure S&P PE. A modest up dollar shouldn't prevent a moderate oil price recovery, but we think oil prices climb slowly to \$60/bbl, which we see as normal. We remain underweight Energy.

Contributor - Ju Wang, Investment Strategist & Portfolio Analyst

Source: Deutsche AM. All opinions and claims are based upon data on 6/2/17 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. For illustrative purposes only.

Contact Information

David Bianco 212 250-8169, david.bianco@db.com

Ju Wang 212 250-7911, ju.wang@db.com

Definitions

Barrel (bbl)	A barrel (b) is a unit of volume which is commonly used to measure crude oil and is defined as 42 U.S. gallons in the United States and Canada, which is about 159 litres.
Earnings per share	Earnings per share is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.
Euro (EUR)	The euro (EUR) is the common currency of the Eurozone states and is the second most important reserve currency in the world after the U.S.dollar.
EUR/USD	EUR/USD is an abbreviation for the relationship between the euro and the U.S. dollar currency pair.
European Central Bank (ECB)	The European Central Bank (ECB) is the central bank for the Eurozone.
Exchange rate	The exchange rate is the rate at which two currencies are traded.
Federal funds rate	The federal funds rate is the interest rate at which banks actively trade balances held at the Federal Reserve.
FX – foreign exchange	FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.
Inflation	Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.
Real interest rate	The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.
U.S. Dollar Index (DXY)	The U.S. Dollar Index (DXY) is a weighted index based on the value of the U.S. dollar versus a basket of six other currencies.
Underweight	A particular security is underweight in a portfolio when it holds a lower weighting in comparison with the security's weight in the underlying benchmark portfolio.

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