Beams of light

In the pandemic's darkness, markets' followspot swings between dollar and euro

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Throughout the long weeks of Italy's lockdown, when even show schedules were upended by the coronavirus epidemic, **Italian TV viewers discovered** (likely, to their amazement) **a great passion for finance**.

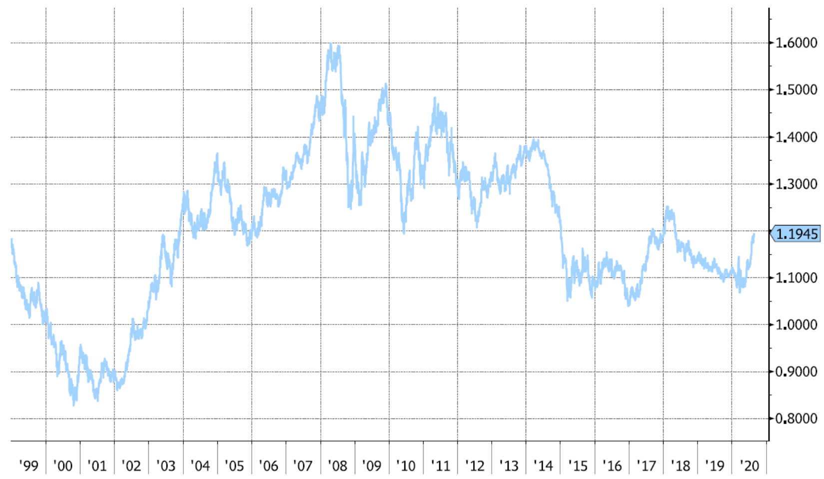
The TV series "Devils," that aired since mid-April and was highly appreciated by audiences and critics, **doesn't have much in common with the** homonymous **novel it is based on.**

Yet, there is **a feature** of the story narrated by financier and writer Guido Maria Brera that **has survived its small-screen adaptation: the description of how**, at some point in the last financial crisis, **the spotlight of international finance shifted from the weaknesses of the United States** and the dollar **to those of the eurozone** and some of its member countries.

After two months of extreme volatility in February and March of this year and a relative stabilization in April around 1.09 dollars, **the euro has been on a path of gradual strengthening against the greenback** starting from the second half of May and now hovers around 1.19 dollars (its highest level in two years).

While the trend of the exchange rate between the two currencies stokes evergreen prophecies about the inexorable end of the American "exorbitant privilege," **there are already those who**, on the contrary, **try to figure out what catalyst will** this time **reposition investors' followspot on the Old Continent**.

EUR/USD spot exchange rate (price of 1 EUR in USD)



Source: Bloomberg

Reference shelf

(Bloomberg) The euro's ascent won't knock the dollar off its perch.

(Bloomberg) The dollar's leading rivals all have their own drawbacks.

(Bloomberg) Europe has a weak dollar problem.

(Bloomberg) Euro rally turns into a renaissance on EU's landmark rescue fund.

(Financial Times) Covid-19 crisis highlights the euro's untapped potential

(Financial Times) Mounting risks in US will weigh on the dollar, analysts predict.

(Financial Times) Dollar blues: why the pandemic is testing confidence in the US currency.

(Financial Times) There is plenty of life yet in the US dollar.

(OMFIF) Exaggerated worries over dollar demise.

(Project Syndicate) From American to European exceptionalism.

(Project Syndicate) The high cost of a strong euro.

(Project Syndicate) Reading the dollar doldrums.

(Project Syndicate) Dollar sensationalism.

(Reuters) Battered US dollar 'hanging by a thread' as coronavirus cases grow.

(Reuters) King dollar's decline ripples across the globe.

(Reuters) How strong is too strong? Euro's 10% rally fans fears of side effects.

(Reuters) US dollar headed lower, in retreat against the euro.

(Wall Street Journal) Behind the vast market rally: a tumbling dollar.

(Wall Street Journal) Turkish lira's fall drives concerns for euro.

Slow recovery

The sudden interruption of the dollar's strengthening trend, that began at the end of the first quarter of 2018, could be explained with a single word: Covid-19.

The US policy response to the economic and financial **fallout of the pandemic has been massive**.

Fiscal measures for a total amount of just under $3tn have been launched by the Trump administration, while the Federal Reserve has cut its benchmark interest rate by 150 basis points between March 3 and 16 (bringing its target rate in a range of 0-0.25%) and has announced unlimited purchases of US Treasury securities (just to mention two of the many initiatives deployed by the Washington-based central bank).

Health-wise, however, **the American reaction to the virus has been** definitely **more uncertain**, as President Donald Trump has long downplayed the risks posed by the epidemic.

Although Europe is not immune to new coronavirus outbreaks, in the United States the situation seems more worrying at the moment -- with over 5m cases (about 1/4 of the global tally) and more than 170,000 deaths -- and **markets have begun to fear that the US economy may recover more slowly than Europe's**.

US real GDP growth will be 3.7% YoY in 2021, compared to 5.7% YoY in the euro area, according to a median of estimates compiled by Bloomberg.

Such expectation has been quickly reflected on the dollar, which fell more than 10% from its March high against a basket of six global currencies (euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc).

According to a Reuters poll, more than half of the 62 currency strategists surveyed between July 31 and August 5 expects the dollar's weakening trend to continue for at least another six months.

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US Dollar Index (DXY)

Source: Bloomberg

Unexpected unity

At first, Europe too didn't shine as for its response to the pandemic.

Before launching a €1.35tn Pandemic Emergency Purchase Programme, the European Central Bank announced just a modest €120bn top up to its already-existing Asset Purchase Programme.

No less than ECB President Christine Lagarde, at the end of the March 12 monetary policy meeting, stated that the Frankfurt-based institution was not supposed to close spreads between eurozone government bonds. To be sure, Lagarde overtly fine-tuned her stance in subsequent interventions.

As for fiscal policy, **before signing a historic agreement on a €750bn Recovery Plan** (aimed at providing €390bn in grants and €360bn in loans to the EU's hardest-hit member countries, funding the scheme through the joint sale of bonds with maturities up to 2058) **European Union leaders have held long and bitter talks**, dividing themselves along usual factions of Nordic and Mediterranean countries.

Despite some initial hesitation, however, **Europe has** (at least for now) **managed to give a strong demonstration of unity** and good handling of the epidemic, ending up benefiting from renewed investors confidence about the future of the euro, a currency that many, at the beginning of the pandemic, saw headed towards a new existential crisis.

The decrease in US interest rates due to the Fed's expansionary measures **has** in turn **reinforced this trend, shrinking the yield gap between the two sides of the Atlantic** and thus reducing the profitability of carry trades, that allowed international investors to borrow in euros, at rock-bottom rates, to reinvest in dollars, at higher rates.

Export dependency

Even rating agencies have started taking note of the impact of the pandemic on the creditworthiness of the US.

Guido Maria Brera
Financier and writer

In Devils I have compared finance to a stage in a theater. It is dark and there is someone who moves a spotlight, a followspot, illuminating certain themes. So, I believe that at a certain point in 2012 they wanted to illuminate the euro, with all its fragility, to make the euro look more fragile and the dollar as a safe haven.

April 14, 2014

On July 31, Fitch has cut to negative (from stable) **the outlook on the United States' AAA rating**, in a move that has called to mind when, in August 2011, Standard & Poor's cut the country's then-pristine credit rating to AA+ in the aftermath of the Great Recession.

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Every cloud has a silver lining, anyway, as **a weak dollar could allow US multinationals to gain competitiveness** and increase their exports (provided there is enough foreign demand for "Made in USA" goods in the current environment of global recession) as well as report higher earnings when overseas profits are converted back in USD.

From this point of view, Europe's situation is almost enigmatic: **the bloc's currency is strengthening on the expectation of a smoother economic upturn** than the US, **but the recovery itself risks being slowed down by the euro's appreciation**, given the Old Continent's significant dependence on exports (with Germany and the Netherlands in the lead).

According to some economists, **the deflationary impact of a strong euro could act as an** additional **incentive for the ECB** to scale up the size (and duration) of its bond-buying program, with the addition of another €500bn to the PEPP within the end of this year.

Presidential election

With US policy rates anchored near zero, certain swaths of the market expect the Fed too to adopt even more heterodox monetary policy measures than those put in place so far, should the country's outlook deteriorate further. In this case, the launch of **a** Japan-style **yield curve control policy could only accentuate the downward pressure on the dollar.**

On the other hand, the analysis of the impact on the greenback of US presidential elections is more puzzling, as **economists expect the dollar to take a hit both in the event of Donald Trump's re-election** (due to the continuation of his isolationist policies and the consequent ever-decreasing centrality of the US currency) **and in case of Joe Biden's victory** (that will likely result in a less erratic presidency than the Republican's, thus reducing demand for dollars as a safe-haven asset).

While **the weakness of the dollar is already generating benefits for the US stock market** (which has always been considered by Trump as the most relevant gauge of his administration's performance), its potential effects on the manufacturing sector (and its workers, that were crucial for Trump's victory in states like Michigan in 2016) could only materialise after the November 3 election.

Currently, **the Democratic White House hopeful is leading in the polls**, with weekly magazine The Economist giving him a chance of winning close to 90%, although the race to the presidency is still long.

Turkish risk

The fall of the greenback, paired with the euro's new-found ambitions (especially thanks to the European Commission's upcoming bond sales, that will rival US Treasuries as an international safe asset), **makes some prospect the decline of the buck as the main global reserve currency** in favor of the single European currency.

However, others point out that **the €750bn** ($888bn) **worth of bonds the European Union is about to issue** to fund its Recovery Plan **pale in comparison to the $17tn worth of US Treasuries currently outstanding**, not to mention that Next Generation EU is only one step on the still long path towards a fully-fledged Europe-wide fiscal union (a key requirement to truly make the euro a credible rival for the dollar).

Beyond suggestions (and the historical perspective, which reminds us that nothing is forever), **it is** therefore **hard to believe that the dollar can lose its coveted status**, **at least in the short- to medium-term**, given a de-facto absence of compelling alternatives on the global monetary stage (not only the euro, but also China's renminbi, Japan's yen, gold, IMF's Special Drawing Rights or some cryptocurrency).

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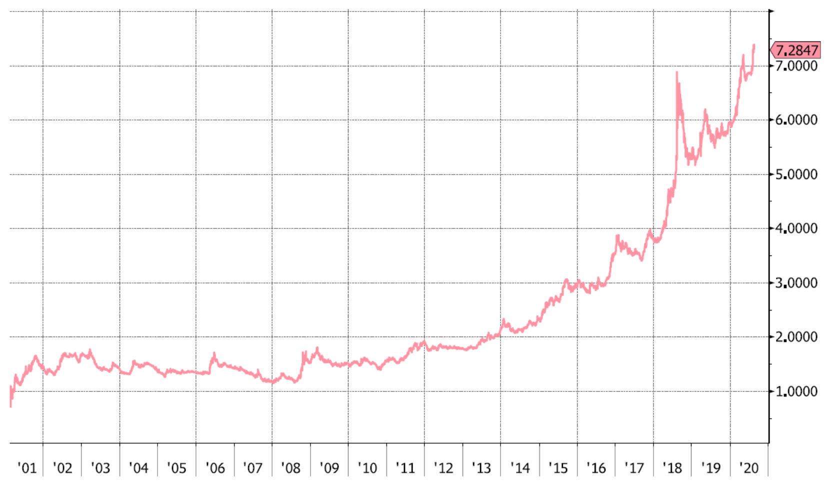
Case in point is the fact that **12 years have passed since the EUR/USD exchange rate hit its all-time high slightly below 1.60**, surrounded by a chorus of forecasts very similar to current ones, yet the greenback's dominance has anything but waned since then (over the last 20 years, the dollar has steadily represented between 60% and 65% of global central banks' foreign exchange reserves).

Currently, the cross is trading well below its 2008 high and **many factors can rather cast their shadow on the Old Continent**, besides a widely dreaded second wave of coronavirus infections.

USD/TRY spot exchange rate (price of 1 USD in TRY)



Source: Bloomberg

The recent collapse of the Turkish lira is the number one suspect in the euro's potential decline, according to the Wall Street Journal.

"The renewed pressure on the currency," the US financial daily says, "is raising alarms about Turkey's long-term ability to repay its foreign [creditors], which include European banks."

"A weaker lira," the August 10 article says, "also makes imports more expensive and threatens to curb Turkey's appetite for goods from Europe."

Perhaps, the markets' followspot has begun to shift.

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