



**Hard to See EUR Story Get Any Better**

The EUR was the star performer in 2013, despite a strong dollar elsewhere. The Euro-area's large current account surplus has helped, which has pushed the basic balance into positive territory and in the past has been associated with broad-based EUR-appreciation. It is for this reason that we expect the EUR to continue to hold up relatively well against many G10 FX. Looking at drivers more relevant to EUR/USD however, the positive factors that have driven strength versus the dollar have peaked.

First, interest rate differentials should turn lower over 2014. Looking across different tenors as well as bond versus implied forward yields, we find that the euro is most sensitive to short-dated forward-implied yields. Last year short-end European yields moved higher not only on the back of ECB LTRO liquidity withdrawal, but as the cross-currency basis also moved back to flat for the first time since 2008 (chart 1). For this year, the risks are skewed the other way. There is less than 200bn EUR of excess liquidity left, EONIA is back to the refi rate and cross-currency basis is flat, so there is no room left for higher short-end European yields. In contrast, the ECB retains a strong easing bias and negative rates or additional liquidity injections remain a strong possibility.

On the flow side, the best is behind us as well. Portfolio inflows into the Euro-area have been dominated by equity, but cumulative purchases are now back to trend and on a relative valuation basis Euro-area equities are at a 10-year high. On the outflows side, European offshore investment remains very pro-cyclical, so an improving cycle should lead to a pick-up in Euro-area outflows (chart 2). Add to that the peak in the current account surplus on the back of recovering domestic demand and the risk of additional ECB easing, and we like buying a 1.42p/1.34c EUR/USD risk reversal for zero cost.

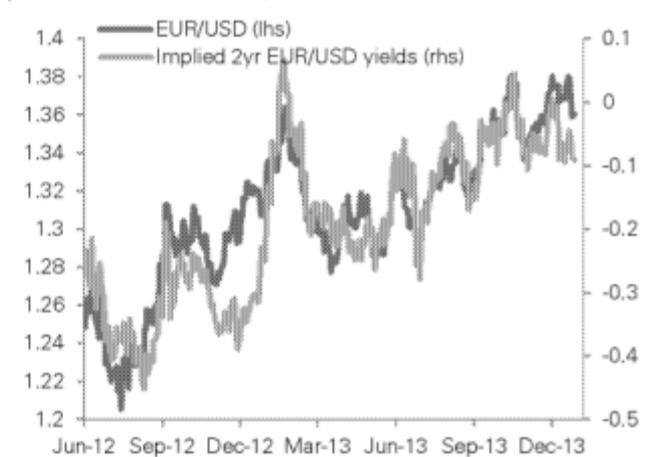
**(a) Other Dollar Crosses to Short**

Looking outside of EUR/USD, NZD, SGD, and CHF are our top shorts. The Swiss franc is a higher beta version of EUR/USD, with valuations more stretched and greater potential for capital outflows. NZD and SGD are the most over-valued currencies in the world, having lagged all other FX in the USD appreciation that has materialized so far. We therefore like buying USD vs. NZD, CHF and SGD. This basket has a steady ~80% correlation with both the narrow and broad USD trade-weighted indices over the last ten years.

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**EUR/USD Still Tracking Rate Differentials**



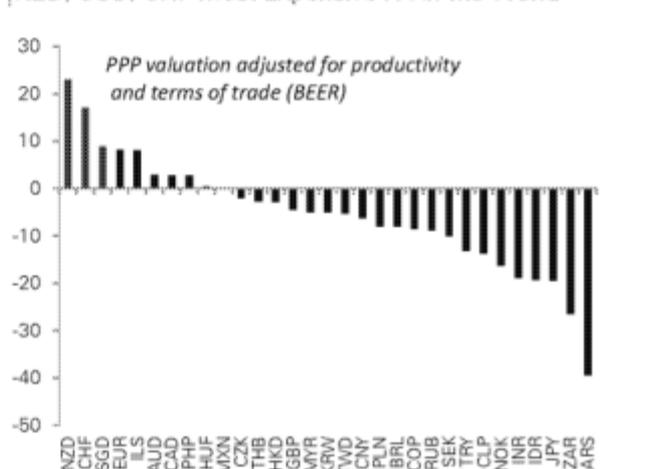
Source: Deutsche Bank, Consensus economics 1-yr ahead expectations

**Portfolio Inflows Into Euro-Area Peaked**



Source: Deutsche Bank, Bloomberg Finance LP

**NZD, SGD, CHF Most Expensive FX in the World**



Source: Deutsche Bank, Bloomberg Finance LP