Global

Economics
Foreign Exchange
Rates

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An update to our EUR/USD view (and forget QE, think QT)

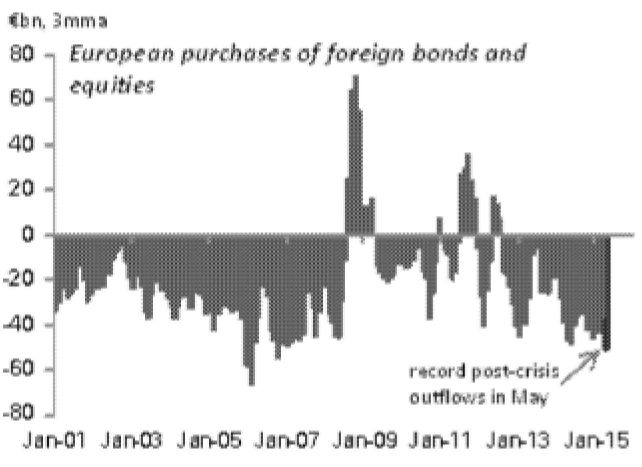
Our bearish EUR/USD view since last year has relied on two major forces: large-scale European capital outflows (what we have called Euroglut) and the eventual prospect of Fed exit from ultra-accommodative policy. How are these two forces lining up as we head into the second half of the year?

The ***European outflow story*** remains fully on track. Balance of payment data released earlier this week showed another month of strong outflows, bringing European purchases of foreign assets close to all-time record highs. Recent trends matter because they cover the large bund sell-off earlier this year. The data shows that higher bund yields have not triggered a change in European investor behaviour. We are not surprised because the UST-German spread remains very wide and unprecedented bond market volatility has further reduced the risk-adjusted attractiveness of Euro fixed income. We continue to see European outflows as part of a multi-year shift in portfolio allocation behaviour towards foreign assets.

What about ***Fed tightening***? The market remains entirely focused on the exact timing of the first rate hike but there are even bigger forces at play. The most important is the Fed's re-investment policy on QE assets, because decisions here will determine the prospect of what would essentially be QT, or quantitative tightening: nearly half a trillion dollars matures in 2016, almost equivalent to a full QE program in reverse. Irrespective of lift-off, the key point then is that Fed tightening is multi-dimensional and likely to steadily reinforce a persistent shift away from the dollar as the world's major funding currency.

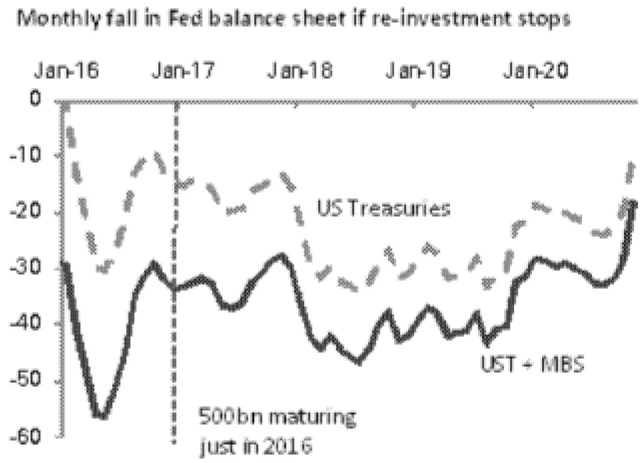
In sum, we remain bearish EUR/USD and after a Q2 lull accompanied by much lighter investor positioning we expect the weakening trend to resume. We continue to target parity by year-end.

Euroglut continues, despite rise in bund yields



Source: Deutsche Bank, Bloomberg Finance LP

We all know about QE, but what about QT?



Source: Deutsche Bank, Bloomberg Finance LP and DB research