



Euroglut a year on: alive and kicking, EUR/USD to break parity

- Back in October 2014 we introduced our “Euroglut” hypothesis. We predicted a wave of European capital outflows to the rest of the world that would keep global yields unusually low and cause dramatic euro weakness despite the region’s large current account surplus.¹
- In this report, we take the opportunity to review the evidence so far. We show that “Euroglut” is no longer a hypothesis but a reality: the Eurozone has experienced a historically unprecedented shift in portfolio flows, with net fixed income outflows running at a staggering 500bn EUR over the last twelve months, the largest on record. These flows are mostly directed towards US bond markets and have exceeded the Eurozone’s current account surplus. They have pushed the basic balance into deficit over the past year contributing to EUR/USD weakness.
- We show that Euro-area portfolio outflows will likely remain in the driving seat for years to come as core Europe’s (mostly Germany’s) vast savings are deployed overseas, while American and Asian investors retreat from European assets. Quantitative Tightening, the reserve draw-down by the major central banks in emerging markets, has only helped to accelerate this process. Bearish pressure on the euro from this structural adjustment is therefore likely to continue irrespective of how much easing the ECB delivers in December.
- We re-iterate our forecast for continued EUR/USD weakness over the course of this decade, with a move below parity in 2016 and a terminal forecast of 85cents by 2017. We also re-iterate our expectation that European demand for foreign assets and bonds in particular is likely to be a persistent source of downward pressure on global bond yields in years to come.
- In this piece we also address some common criticisms of our thesis, not least in a recent article by economists at the Federal Reserve Bank of New York. We counter their arguments that capital outflows have not been a driver of euro weakness.

Introduction

It has been more than a year since we first introduced our Euroglut thesis² which has since drawn criticism from many corners, not least in a recent article by economists at the New York Fed. Partly in response to such criticism, we take the opportunity to review developments in the Euro-area balance of payments over the last year and compare our predictions to realized outcomes.

¹ DB Special Report, “Euroglut: a new phase of global imbalances”, 6 October 2014. In this report we argued that the European current account surplus was not an obstacle to significant euro weakness but rather a symptom of a huge pool of excess savings. We predicted that the combination of large European savings with aggressive ECB easing would unleash a wave of capital outflows from the euro-area with significant global implications: the euro would weaken dramatically and global fixed income yields would stay persistently low as Europeans invested abroad. The portfolio rebalancing progress would not be complete until the Euro-area’s net international investment position shifted into significant positive territory, similar to other economies running large current account surpluses.

² See footnote above