



Europeans abandoning Europe

On the other side of the Atlantic the recovery remains intact but the euro has not been responsive to better European data. Ongoing ECB dovishness, negative yields, and European investors' large underweight in foreign assets all suggest that these outflows are likely to continue, a phenomenon we have previously termed Euroglut. Interestingly, the composition of portfolio flows between different investors has undergone a significant transformation over 2015. Non-bank portfolio flows have become the dominant portion of Euro-area capital outflows, suggestive of underlying shifts in European investor preferences rather than changes to bank balance sheets that are also typically hedged (chart 4).

ECB taper not important as Fed rate hikes

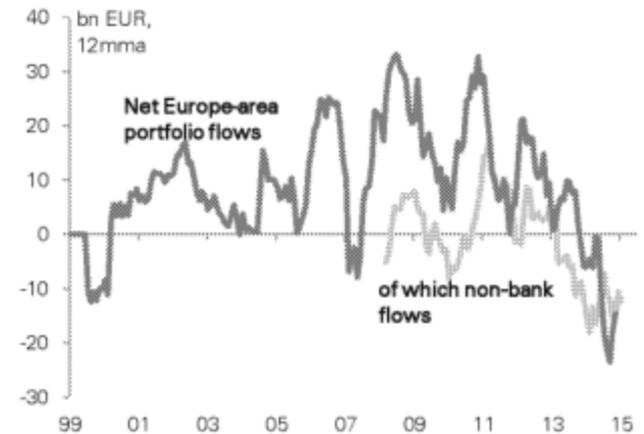
Persistent weakness in the oil price and downside surprises to inflation suggest that the risks are skewed toward more ECB easing this year. But could a decision by the ECB to taper its QE purchases later mark the end of the EUR/USD bear run and by extension the long-term dollar up-cycle? It is doubtful this would be the case because ECB decisions on QE are more relevant for the long-end of the European curve rather than near-term rate expectations. The latter in turn exert significantly higher influence on FX (chart 5). So long as the European short-end remains anchored, it will be the pace and timing of the Fed cycle that will dominate dollar drivers rather than the pace of ECB QE.

China and risks to dollar outlook

The biggest risk to our dollar view is a significant slowdown in the US economy that stops (rather than decelerates) the Fed hiking cycle and potentially brings easing back on the table. Beyond that, portfolio flows, relative central bank cycles, and China's recent willingness to tolerate more dollar strength all suggest the dollar has more scope to appreciate in 2016. The latter is particularly important because past USDCNY stability has prevented the broad trade-weighted dollar from appreciating as much as the narrow index given China's high weighting. Given our ongoing bearishness on RMB (see theme 3) we therefore prefer the broad over the narrow trade-weighted dollar, which also remains cheaper on account of CNY valuations. Indeed, even if the current dollar rally is faster than the late 1990s, it remains well within the bounds of previous dollar cycles. We remain bullish on the dollar while also looking for a move down to 95cents in EUR/USD by the end of the year.

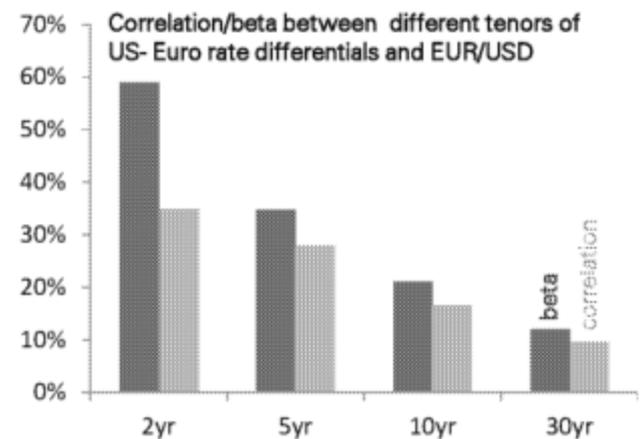
*George Saravelos, London, +44(20) 754 51947*

European outflows are being driven by "real" flows



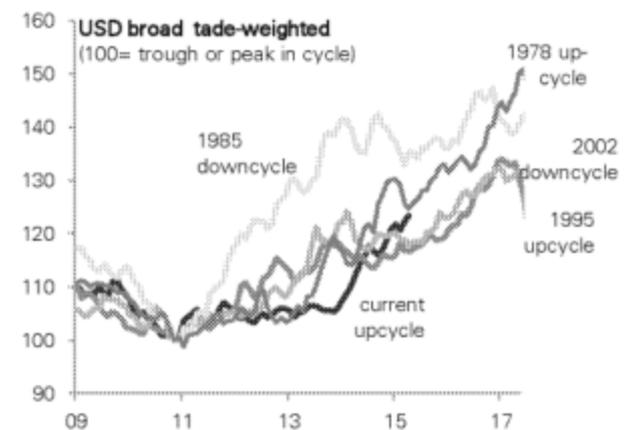
Source: Global Markets Research; Bloomberg Finance LP

Fed policy (and short-end) matters more than ECB QE



Source: Deutsche Bank, Bloomberg Finance LP

Dollar cycle not unusual or extreme



Source: Deutsche Bank, Bloomberg Finance LP