Trade Idea – Foreign Exchange
Common currency to resume decline
7th January 2016

**Euro rebound to cease**

- After a prolonged period of speculation and rhetoric, last month the European Central Bank (ECB) finally delivered upon its promise to “do what is necessary” to support price stability in the Eurozone. ECB president, Mario Draghi, detailed the central bank’s plans to extend its current quantitative easing program by a further six months and cut its deposit rate by 0.1% to -0.3%. While these additional monetary measures are indeed significant, they fell well short of market expectations, which sent the EUR/USD exchange rate soaring over 3% in a single day (Source: Bloomberg), the largest one day move in over six years. This left the Euro at higher levels against the US Dollar then fundamentals would imply. We believe that this presents a good tactical opportunity to build short exposure to the Euro against the US Dollar, particularly as we expect that in Q1 2016 that the improving inflation outlook in the US will emphasise the ongoing rate divergence across the Atlantic.

**Wage gains and base effects to prompt higher US inflation**

- Following the US Federal Reserve’s (Fed) decision to initiate its long awaited rate hiking cycle in December, the market has priced in expectations for approximately three further rate rises in 2016 (Source: Bloomberg), which is in contrast to the Fed’s own median estimate of six hikes. We believe that the Fed’s estimate will prove to be more accurate as US inflation and general inflation expectations rise faster than is currently anticipated as a result of healthy wage growth and the base effects of falling oil prices dropping out of headline numbers (see Figure 1). Over coming months, we expect the EUR/USD exchange rate to be pushed closer to parity (see 2016 Outlook: Don’t believe the hype) as market expectations of inflation and interest rate movements catch up with the Feds’ own forecasts.

**Figure 1**

Impact of energy decline to fade...
Internal wage pressures climb in the US...

![Impact of energy decline to fade...](source:Bloomberg, ETF Securities)

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**Nominal yield differential suggests forthcoming correction**

- Diverging rate expectations have driven the EUR/USD exchange rate in the past 18 months as clearly shown in Figure 2 below. However, since the ECB’s monetary policy meeting on December 3rd last year, short term nominal yield differentials have diverged from EUR/USD levels. We believe this will correct in coming months as the ECB maintains its loose policy stance and the Fed ploughs ahead with its own tightening agenda, sustaining the divergent rate outlook.
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