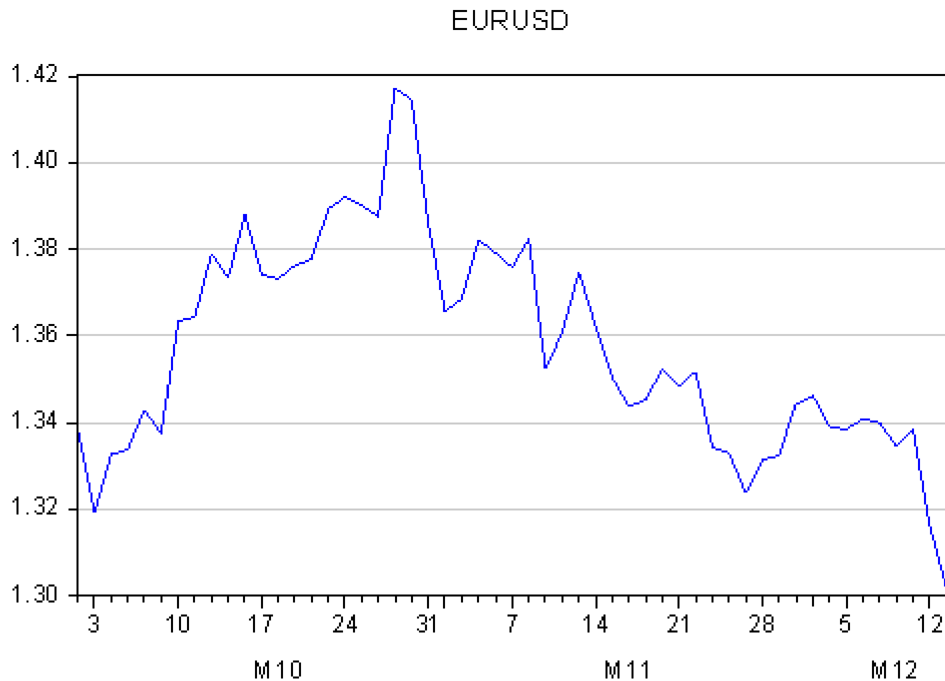
Currencies: A structurally weaker euro?

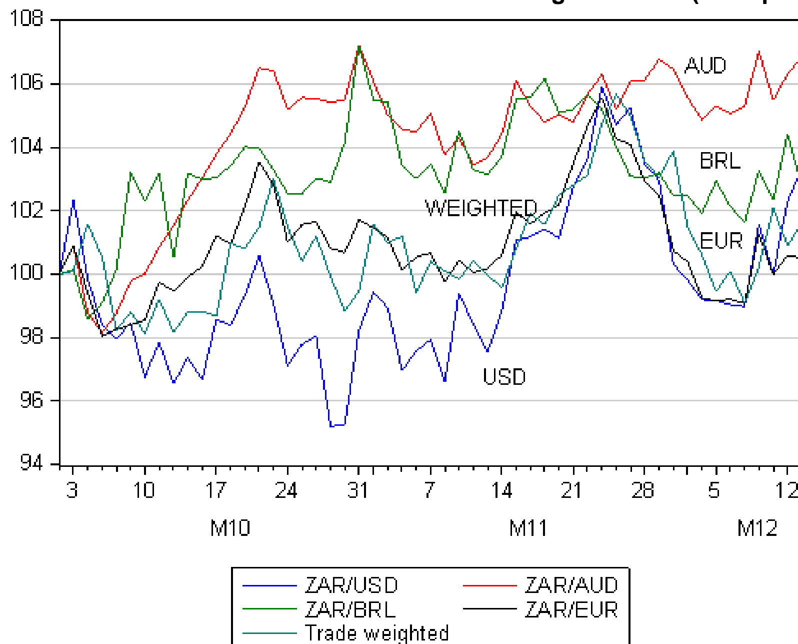
The big new story in the currency markets is not the weakness of the rand or the strength of the dollar – but the weakness of the euro. The euro, which was worth as much as 1.417 US dollars on 27 October, is now trading at close to 1.30.



Source: I-Net Bridge and Investec Wealth & Investment

The rand this quarter is now almost unchanged against the euro, and is consequently 3% weaker against the US dollar, weaker still against the Aussie dollar (by about 6% but unchanged since late October) and about 2% weaker against the Brazilian real, having recovered some lost ground over the past three weeks. The trade weighted rand is now back where it was at the beginning of the quarter, having recovered from greater weakness earlier in the quarter. (See below where we have expressed the nominal trade weighted rand similarly as the rand cost of foreign currencies.)

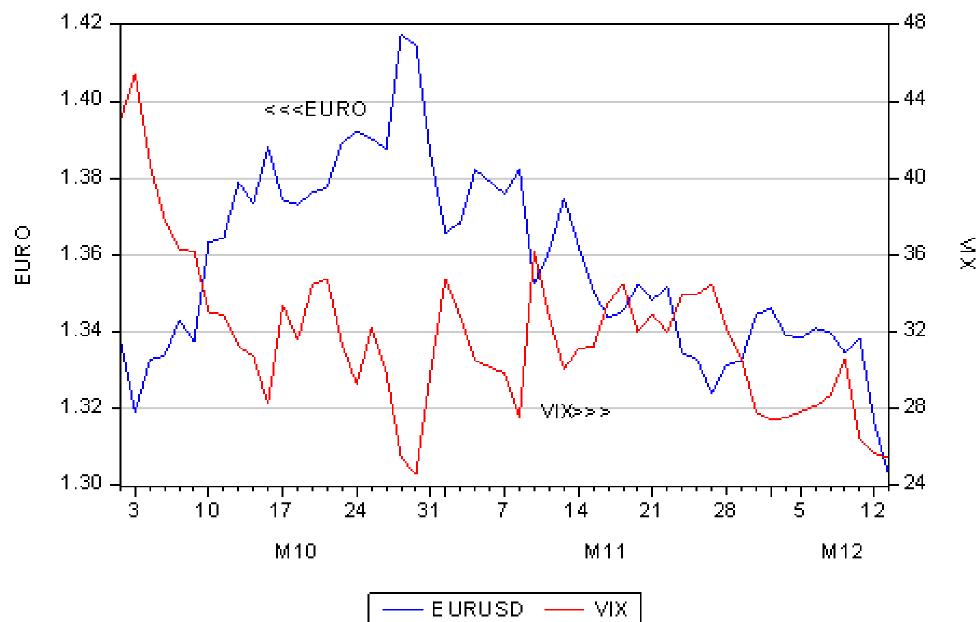
The rand vs other currencies and on a trade weighted basis (30 Sept 2011 = 100)



Source: I-Net Bridge and Investec Wealth & Investment

Earlier this quarter and until this week, as the risks to the global economy and the earnings of companies associated with the euro debt crisis increased (for example the equity volatility indicator [the VIX] moved higher and the risk spread on emerging market bonds widened), the euro weakened as investors sought out the safe haven US dollar. What is new about these very recent moves in the euro (that is since the European leaders agreed on the weekend to sign a debt and deficit reduction compact) is that a weaker euro and strong US dollar are now linked to less, rather than more, risk (as revealed in the equity and bond markets). The weekend agreements and the actions of the ECB in support of European banks have been well received in the markets. Less risk is being priced into share options and bond spreads; and yet the euro has weakened.

The euro and the risks to global growth (represented by the VIX - the fear Index)



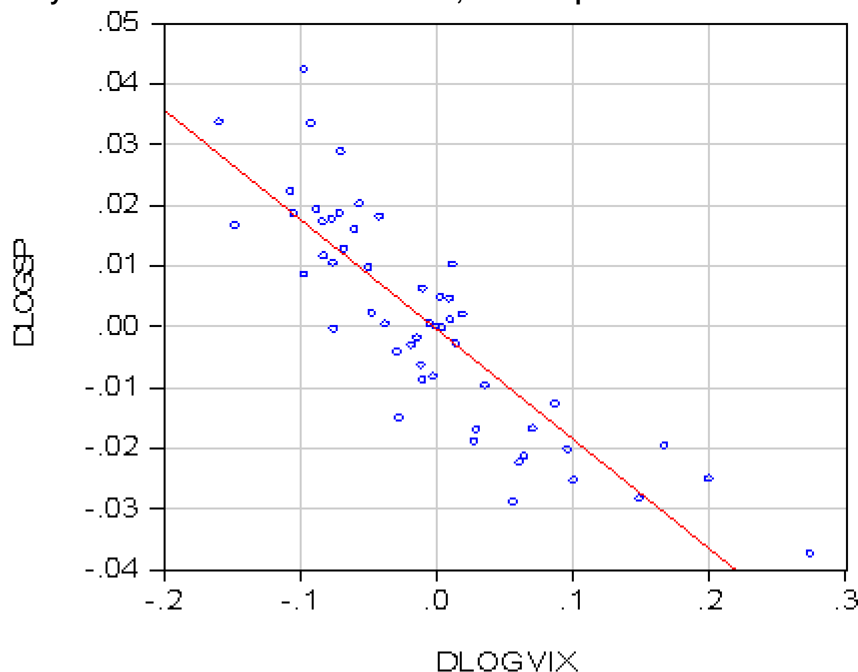
Source: I-Net Bridge and Investec Wealth & Investment

The explanation for this must be that the market is of the view that the support for euro debt promised by the new fiscal compact will stabilise the debt markets. Such support would include the promise that private lenders to all European governments signing up to the compact, will never again have to suffer the haircuts they have been forced to take on Greek debt. But this support will be associated over time with more euros in issue and therefore a structurally weaker euro.

This makes sense to us: rescuing the euro and providing guarantees for future euro debt does impose additional responsibilities on the fiscally sound (that is the Germans) and is thus presumably enough of an additional potential fiscal burden to imply a weaker euro. The weaker euro will be very welcome to all the European economies seeking growth through exports, especially to German exporters. It should also be welcome to shareholders concerned about the implications of austerity in Europe for earnings. A weaker euro has become part of the solution rather than part of the problem of euro debt.

The relationshipship between risk and equity market returns remains as close as ever. Less risk, as revealed by moves in the VIX, is still being strongly associated with higher equity valuations and vice versa. The correlation between daily moves in the VIX and the S&P 500 Index has been high. ***Brian Kantor***

Daily moves in the S&P 500 and the VIX, a scatter plot



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