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Two canaries in the coalmine

Gerhard Winzer

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The US dollar has appreciated significantly vis-à-vis the euro in the past months. For this trend to continue, at least two developments would have to be in place. Firstly, the US Fed would have to abandon its zero interest rate policy; and secondly, the ECB would have to remain on its path of negative interest rate policy and bond purchases.

The ECB policy has kept the bond yields in the Eurozone on very low levels. Among other things, this causes investors to be pushed into other asset classes that promise higher yields, e.g. US Treasury bonds, which in turn weakens the euro relative to the US dollar.

Even though the economic data have been on the disappointing side over the past weeks – the US economy is transiting from the recovery from the Great Recession in 2008 and 2009 to self-sustaining expansion. In line with this scenario, the end of the zero interest rate policy is drawing closer in the USA. The US Fed already ended the bond purchase programme in autumn of 2014.

Of course the divergence of the monetary policies in two monetary blocks does not trigger a sustainable trend in exchange rates. The development of interest rates, exchange rates, and economic growth are self-regulating.

The appreciation of the US dollar reshuffles the relative importance and impact of economic growth and inflation from here on out. The general rule is: the stronger the US dollar, the later and less substantially the US central bank will raise the Fed funds rate. The daily spread for the default risk of corporate bonds can be used as indicator of the extent to which the US economy has been negatively affected. And indeed, the spread has widened from 1.06 percentage points in June 2014 to currently 1.35 percentage points.

Conversely,the depreciation of the euro supports economic growth and inflation in the Eurozone. The inflation expectations have already increased a bit. More specifically, the average annual rate of inflation priced into the bond market for the coming ten years has increased from its low of 0.60% in January to 1.21% at the moment. The more the inflation expectations increase from their currently still low levels, the shorter the ECB will cut its current highly expansive policy. If the ECB policy is successful, the causal chain will turn around (euro [Symbol] economy). At the moment the weak euro is supporting the economy. Once the economy is running on a self-sustaining basis (i.e. without the support from the monetary policy), the euro will appreciate.

At that point we will have come full circle. The higher yields in the USA will cause the US dollar to appreciate. At some point the US dollar will be so significantly overvalued that Eurozone bonds are more attractive in spite of the low yields because of the strongly rising expectations of an appreciating euro. This could also be the – admittedly, speculative – rationale of the ECB. When it starts tapering the bond purchase programme, the euro will be undervalued and thus attractive in terms of foreign currencies. The spread for default risk in the USA and the inflation expectations in the Eurozone can be resorted to as two indicators of how close we are to that point.

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