From: Richard Kahn [redacted]
Sent: Wednesday, August 30, 2017 7:01 PM
To: Paul Barrett
Cc: Jeffrey Epstein
Subject: Fwd: DB Research: EUR/USD Update

Richard Kahn
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Begin forwarded message:

From: Vahe Stepanian [redacted]>
Date: August 30, 2=17 at 2:37:55 PM EDT
To: Tazia Smith [redacted] >, Alison-T Sinicropi [redacted]
Su=ject: DB Research: EUR/USD Update

Good Afternoon – happy end of summer to you!=Please see below note from George Saravelos (DB's Global co-Head of=FX Research) on EUR/USD.

He lists reasons as to why the current euro level does not ap=ear particularly extreme and most importantly, that the ECB has not been driving recent appreciation anyway. W=ile the ECB's verbal rhetoric may cause a correction, he describes w=y it seems unlikely to be enough to derail euro strength.

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Regardl=ss, we encourage you to take a look and let us know if you have any questio=s or would like to connect with any of DB's thought leaders.

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Thank y=u,

Vahe

-----Original Message-----

From: George Saravelos
Sent: Wednesday, August 30, 2017 05:21 AM Eastern Standard Time<=r> To:
Subject: EUR/USD update

Full link: http://pull.db-gmresearch.com/p/10723-6B86=245613999/5782f31e-8cc1-11e7-b63f-32933503902d_604.pdf <http://pull.db-gmresearch.com/p/10723-6B86/245613999/5782f31e-8cc=-11e7-b63f-32933503902d_604.pdf>

What next for the euro now that our 1.20 EUR/USD t=rget has been met so soon? The ECB meeting is coming up next week and there=are rising risks of verbal intervention from Mario Draghi. Despite this the euro level does not appear particularly=extreme and most importantly the ECB has not been driving recent appreciati=n anyway. ECB verbal rhetoric may cause a correction but is unlikely to be e=ough to derail euro strength. We see the risks as still skewed towards the euro overshooting above 1.20 a= some point this year rather than permanently reversing lower.

First, on technical=, we highlighted earlier in the year that the EUR/USD range was too narrow. The rally up to 1.20 brings the year's EUR/US= range to 17 big figures, a little below the average since 2010. In other w=rds, there is nothing "unusual" about the current size of t=e EUR/USD move compared to the last few years (chart 1).

Second, on valuatio= grounds, EUR/USD is only just now approaching "fair value" on a number of our metrics. Our estimate of purchasing power=parity (PPP) for the euro is 1.23 (chart 2). Our fundamental effective exch=nge rate (FEER) model which adjusts for the euro's large current ac=ount surplus is 3% higher. The BEER model which adjusts PPP for productivity and terms of trade is a little lower. The same=conclusions apply to the trade-weighted index, there is nothing unusual abo=t the euro's current valuations.

Third, on speculati=e positioning, while longs have been building, they are not particularly extreme. The aggregate non-commercial long on the CFTC=is at the 90th percentile going back to 1999, but this does not account for=rising trading volumes over time. Adjusting for open interest, longs are on=y at the 56th percentile, close to average since the euro's inception. For hedge funds specifically=the euro long is even lower at around the 40% percentile (chart 3).<=:p>

Fourth, on portfoli= flows, the most important question for the euro is whether the structural underweight that has built up post-crisis has been a=justed. The IMF portfolio survey (CIPS) is the most comprehensive data sour=e for this and as of last year it showed that American and European investo=s' euro allocations were close to decade lows (chart 4). Reserve managers have been holding an underweight=too (charts 5). Even though this data is very lagged, the key observation i= that it has taken a very long time to build the underweights and it will l=kely be difficult to cover in just a few months.

Taking it all together the 1.20 level in EUR/USD does=not seem particularly extreme. The single biggest risk to EUR appreciation i= its pace. With the trade-weighted having risen by more than 5% in just three months, this has typically driven verba= intervention by both Trichet and Draghi in the past (chart 6). Despite thi=, verbal intervention may not be a game changer. First, everyone is now exp=cting it. Second, for verbal intervention to be credible the ECB will need to abort its QE exit plans fo= October. Our economists do not believe EUR strength is large enough for th=s to happen. The current level of the euro would only require a 0.2% upward=revision to European growth over the forecast horizon to maintain the ECB's inflation path. It is only a= 1.25 or above where tapering would be aborted (chart 7). Third, the Fed re=ction function is just as important and it will be very difficult for the m=rket to aggressively re-price the Fed in coming weeks, a phenomenon we have previously characterized as t=e zombification <http://pull.db-gmresearch.com/p/10686-92CD/10819692/6ab2809a-5=9b-11e7-9c58-87f42c8f0663_604.pdf> of the US hiking path. Finally, and most importantly, mone=ary policy is simply not the main driver of EUR appreciation (chart 8). The=market is becoming more structurally optimistic on Europe versus the US and=the ECB may not be able to do much about it.

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Managing Director

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