SPECIAL REPORT

April 29, 2024

Sell Some Euros, Buy Some Bunds

In This Report

The euro seems to be precariously suspended on the precipice of a sharp fall, and we are tempted to go short the currency (**Chart 1**). At the same time, long-dated German bunds could prove to be the best performer in the G7 "risk-free" sovereign universe this year and in 2025. We have been long 10-year German bunds while shorting 10-year JGBs since August 2023. With inflation falling quickly across the eurozone (EZ), bond managers should consider overweighting long-dated German bunds.

Cyclical Backdrop

The bearish case on the euro and bullish case for German bunds rest on three broad considerations. First, although eurozone inflation shot up later and peaked at higher levels than the U.S., its disinflation process has progressed faster and smoother than the U.S., which has suffered a resurgence in various measures of price increases lately.

Chart 2 highlights that while disinflation in the U.S. has stalled, it continues in the eurozone. With EZ inflation at 2.4%, monetary authorities are within striking distance of reclaiming price stability. In a recent interview, European Central Bank (ECB) President Christine Lagarde indicated that the central bank may well begin to drop rates this summer, despite inflation setbacks in the U.S.

This is not surprising, as inflation in Germany and France, the two biggest EZ economies, has almost reached 2%. These developments are in stark contrast to the recent inflation resurgence in the U.S., which has unsettled, if not rattled, Federal Reserve policymakers. Correspondingly, the forward market has pushed out all but one rate cut from the Fed this year (**Chart 3**).

Chart 1 EUR Looks Precarious

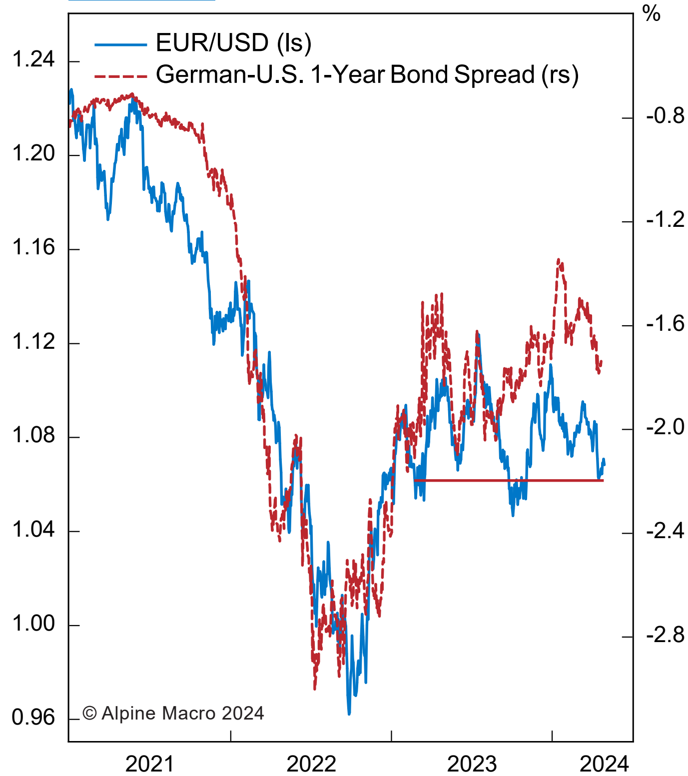


Chart 2 **EZ: Inflation Peaked Later But Falling Faster**

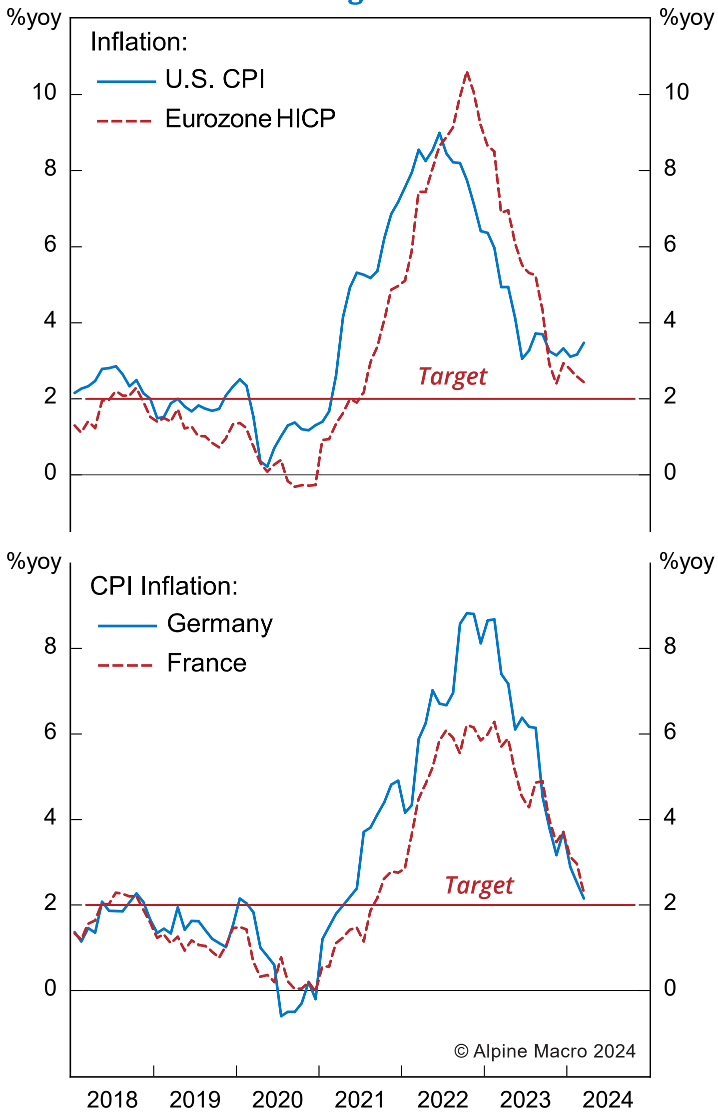
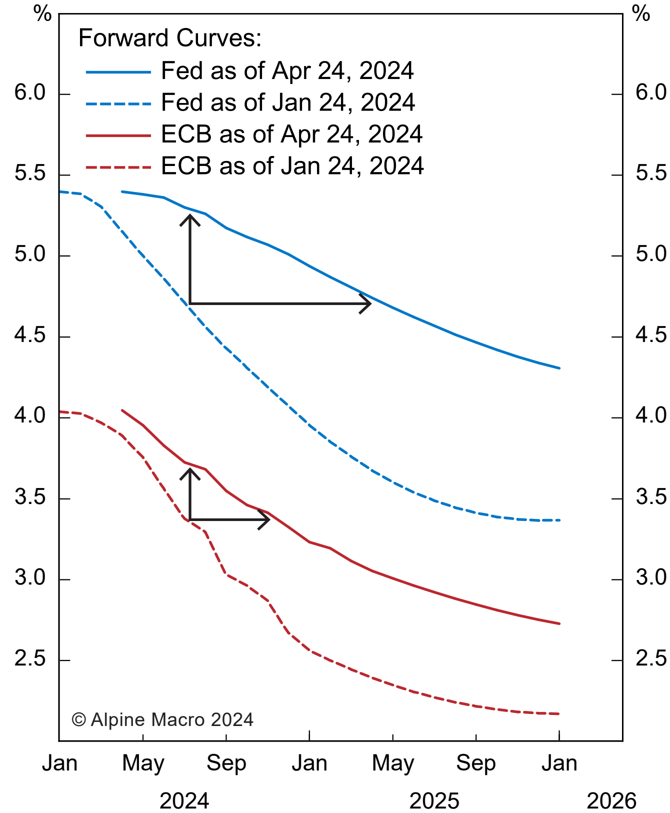


Chart 3 **Rate Expectations: ECB Versus Fed**

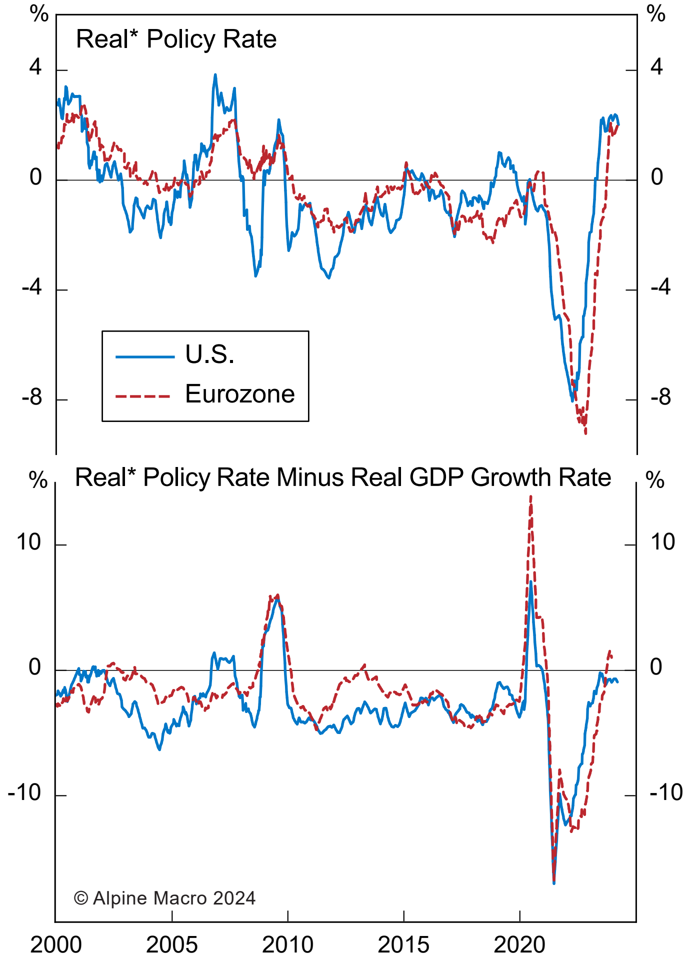


The market has also reduced bets on expected rate cuts by the ECB this year. In January, the market was looking for a 2.5% ECB policy rate by year-end, implying a total of 150 basis-point easing for the year. Today, the market is discounting a total decline of 75 basis points, starting from June.

Two factors have led to reduced bets on ECB rate cuts. The first is the recent drop in the euro, which is inflationary, all else being equal. The second is emerging signs of a bottoming EZ economy led by the service sector. Regardless, the rate differentials between the ECB and the Fed will increase, not decrease. This has been, and will continue, weighing down the euro versus the dollar.

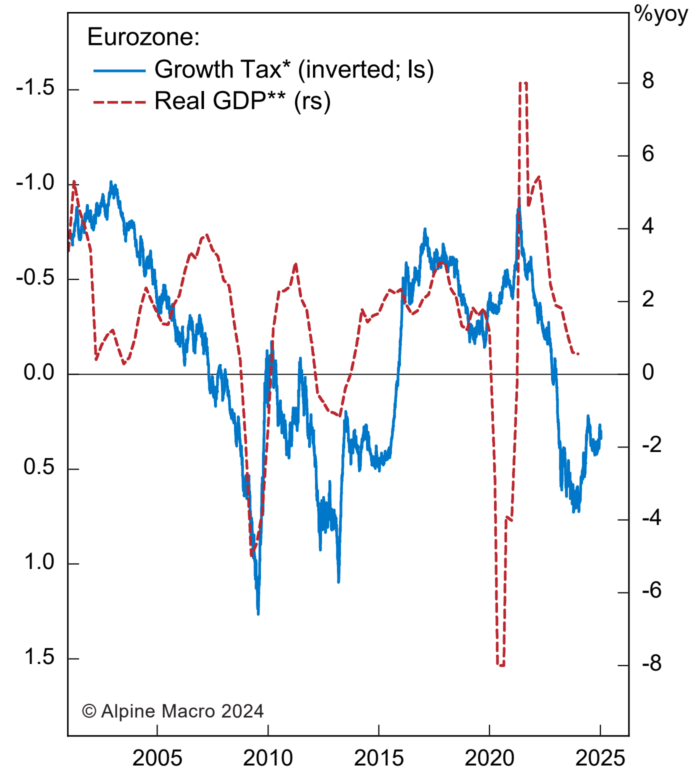
Second, one could argue that ECB policy is tighter than the Fed's relative to their respective economies. On the surface, the ECB's tightening campaign has been less aggressive than the Fed, with total rate hikes amounting to 450 basis points. The Fed, however, has driven up rates by 525 basis points. Nevertheless, Europe's underlying growth potential has been less than half of America's, and steady-state inflation is also lower.

Chart 4 ECB Policy Is Tighter Than The Fed



*Deflated by U.S. CPI and eurozone HICP, respectively

Chart 5 EZ: "Growth Tax" Versus GDP



*Based on EUR, oil price, interest rates and PPI, standardized and advanced by 9 months
**Truncated at +/-8%

Chart 4 shows that Europe's real policy rate is on par with the U.S. Importantly, the real policy rate in Europe is higher than real economic growth, a condition that has often caused an economic slump and/or too low a rate of inflation in the region. However, this is not the case in the U.S. where the real fed funds rate remains below GDP growth.

The EZ economy has been stagnating for over a year, with GDP levels today remaining slightly lower than a year ago. Two major punches – the energy crunch as a result of the Russian invasion of Ukraine and the ECB's aggressive monetary tightening – have dealt a heavy blow to the EZ economy. **Chart 5** plots how the "growth tax" has dragged the economy into stagnation.

By the same token, with inflation under control, it is all too natural to see the ECB push down rates much earlier and potentially faster than the Fed. This may weaken the euro, but also pave the way for a major rally in bunds. Equities will also benefit from a falling euro and monetary easing.

Third, fiscal policy is very different between the EZ and the U.S. While the Biden administration has been pushing for fiscal stimulus since the second half of 2022 *via* various spending/investment programs, there has been a general fiscal retrenchment in the EZ.

Chart 6 U.S. Versus EZ: Very Different Fiscal Policy

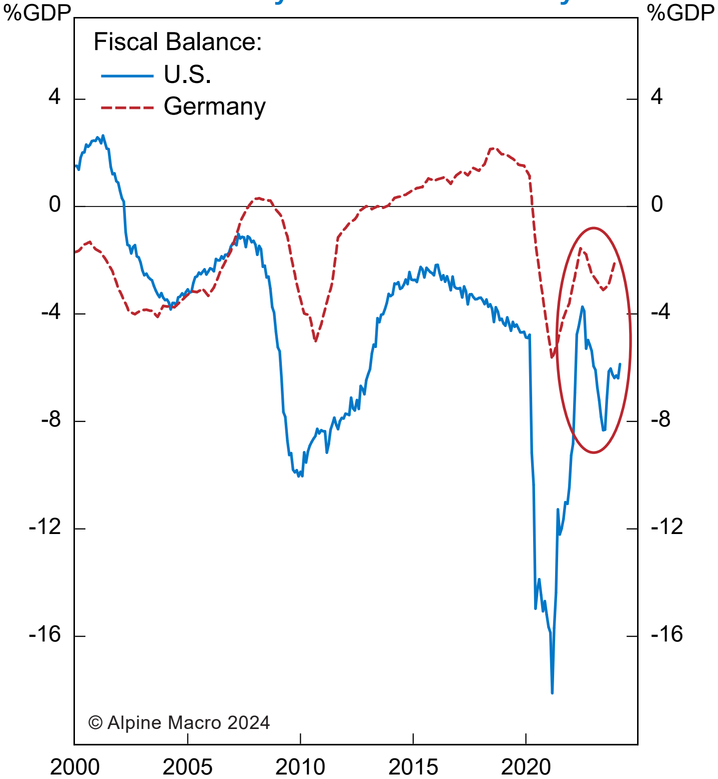


Chart 7 EZ Versus U.S.: Different Disinflation Dynamics

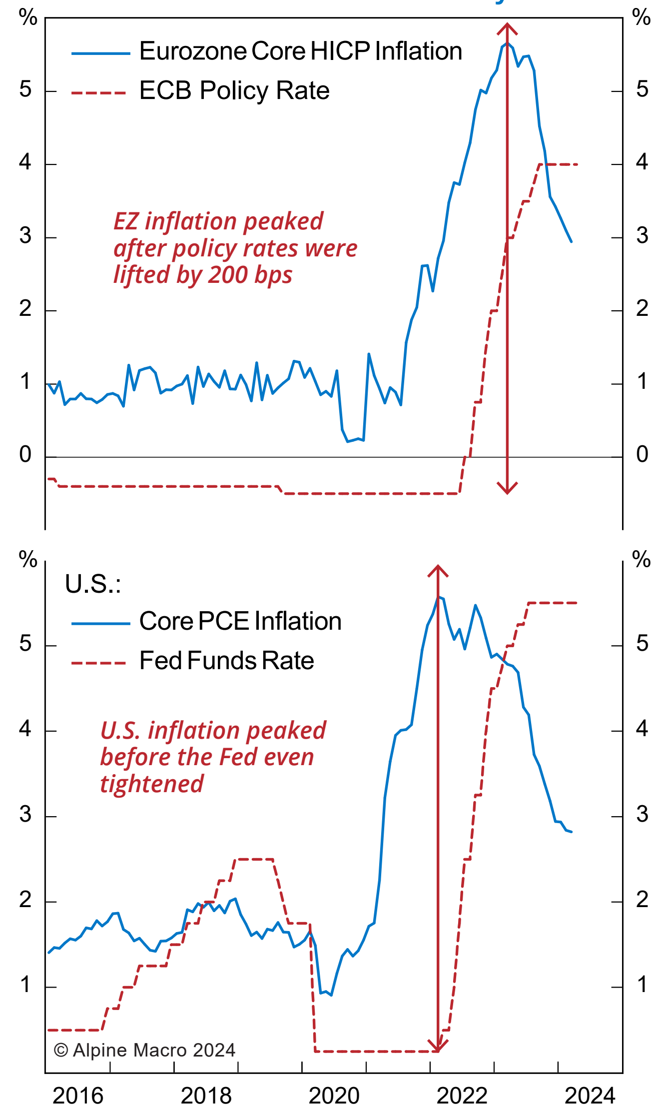


Chart 6 shows that between July 2022 and July 2023, the U.S. budgetary deficit shot up by US$1.3 trillion, or about 5% of GDP. However, most EZ economies, Germany in particular, have been under severe fiscal constraint, weighing on overall growth.

This different fiscal policy partially explains why the inflation dynamics are different between the U.S. and the EZ. Buoyant domestic demand has probably made U.S. inflation stickier than most anticipated, while stagnating spending in the EZ has constrained the pricing power of suppliers, thus bringing down inflation more quickly.

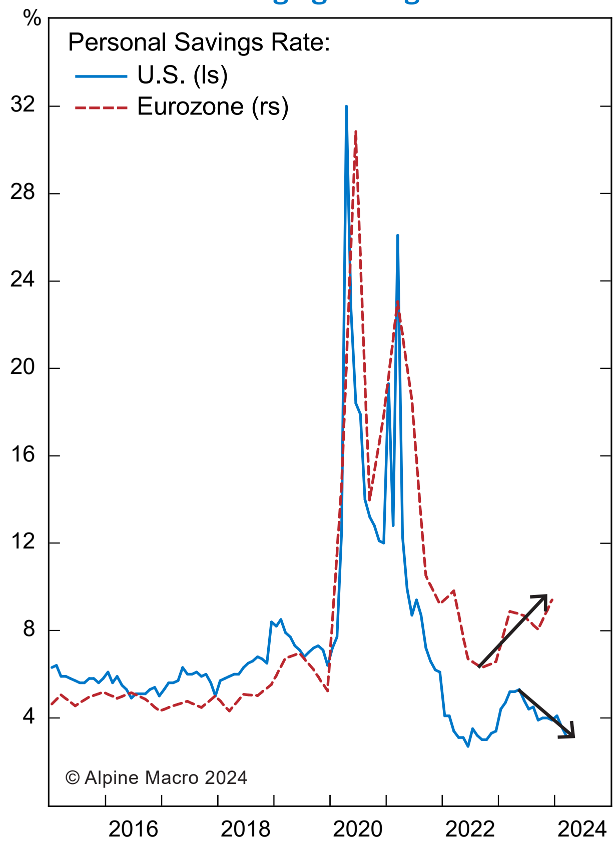
From a policy viewpoint, fiscal expansion has forced the Fed to hold rates "higher for longer" to compensate for fiscal stimulus, while fiscal drag is pushing the ECB to drop rates to salvage economic growth.

The different policy settings between the two argue for a weaker euro versus the dollar.

Finally, the disinflation process is somewhat different between the U.S. and the EZ: while supply-side adjustments have played a big role in pushing down U.S. inflation, weak demand has been the key driving force behind Europe's disinflation.

Chart 7 shows that U.S. core PCE inflation peaked out in February 2022, one month earlier than the

Chart 8 EZ Versus U.S.: Diverging Saving Rates

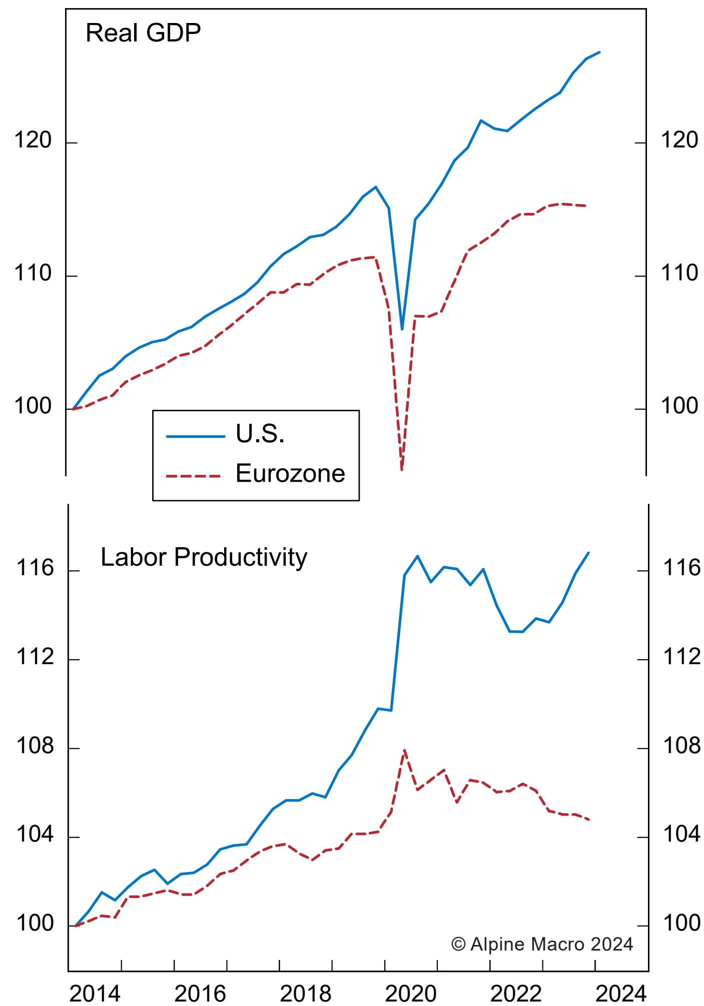


Fed began to hike rates. Therefore, policy tightening was too young to have any impact on disinflation in 2022 and most of 2023. Even today, it is still debatable whether Fed policy is restrictive enough to soften aggregate demand.

Disinflation in the EZ has played out differently. Core HICP inflation peaked out a year ago after the ECB had lifted rates to 2.0%. This played a role in dampening consumption while pushing up the savings rate (**Chart 8**).

In the U.S., however, the savings rate has fallen despite rising rates, which has made Fed policy much less effective than the ECB in terms of aggregate demand management.

Chart 9 Why Has The EZ Economy Shrunk Relative To The U.S.?



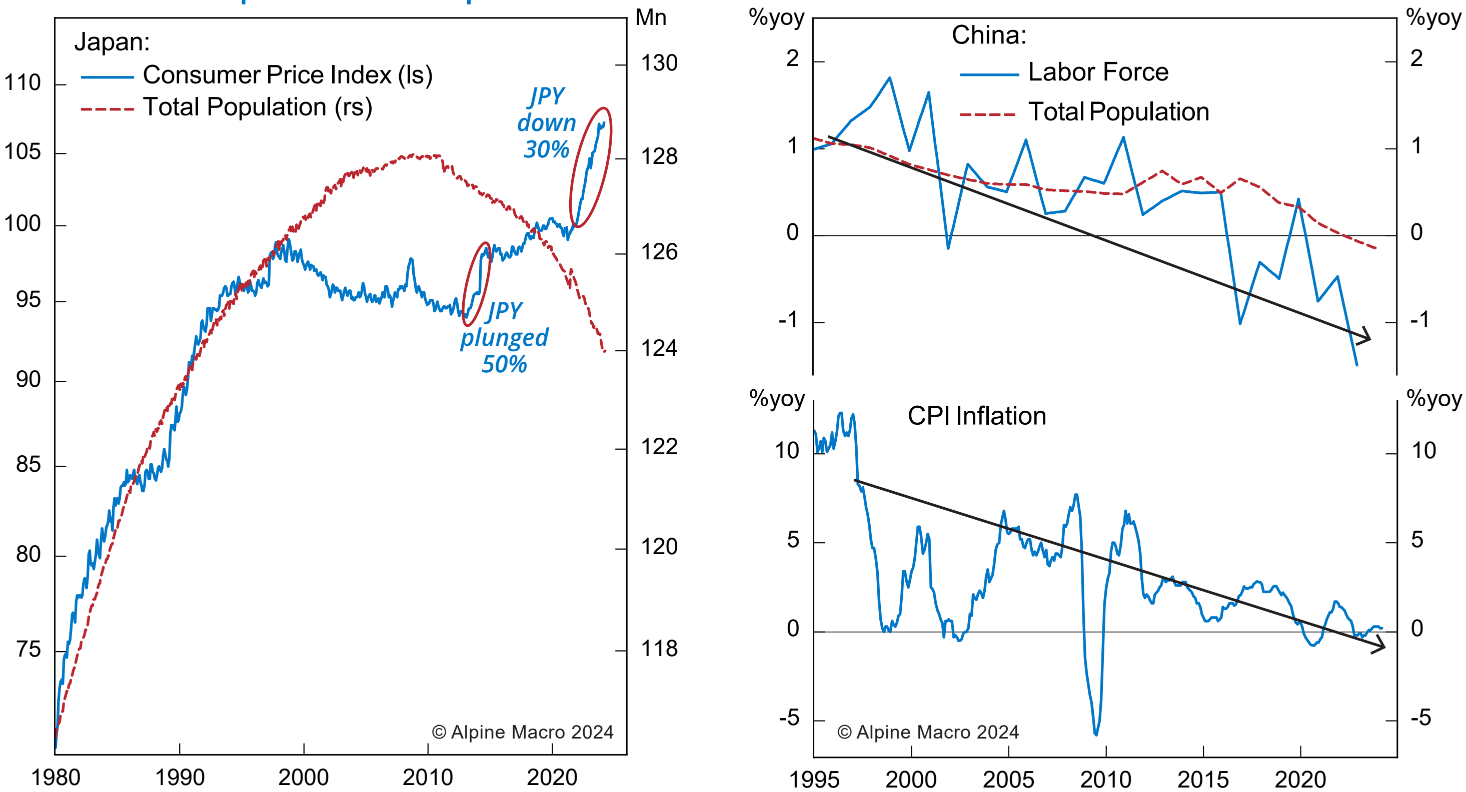
Note: All series are rebased to Q1 2014=100

Some Secular Considerations

It is no secret that the EZ has been lagging the U.S. for decades in terms of economic growth. **Chart 9** shows that for the past 10 years, the EZ economy's underperformance is entirely attributable to a fall in productivity relative to the U.S.

As a result of a relative decline in labor productivity, European living standards, measured as per capita GDP in constant dollar terms, have fallen by 12-13% relative to that of the U.S. Within the

Chart 10 Population Growth Has A Huge Influence On Secular Trends In Inflation: Japan And China Experiences



EZ, the performance dispersion is wide, ranging from an absolute decline in per capita GDP in Italy since 2010 to no growth in France to a very modest increase in Germany.

There are three important issues worth mentioning here.

First, since 2014, labor productivity growth in the EZ has averaged 0.5% per year, while the total labor force has grown by 4.4%, translating into 0.37% annual growth. Using past data as a guidance for the future, the steady-state growth rate should be around 0.87% (labor force growth plus labor productivity growth) for the EZ economy. At present, the real policy rate is 1.6%, suggesting that the ECB policy rate is very restrictive.

This means some policy boost is necessary to break the economic stagnation. Such a boost could be monetary, fiscal, or come in the form of cheap energy. If neither cheap energy nor activist fiscal policy is possible, then the burden of adjustment has to fall on the shoulders of the ECB. Importantly, as inflation moves lower, the ECB needs to quicken its monetary easing to avoid undue damage to economic growth.

Second, while U.S. labor productivity has snapped back quickly after the pandemic slump, it has continued to languish in the EZ, with output/hour having fallen four years in a row (**Chart 9**, bottom panel). It is not clear at this point why European productivity has fared so poorly, but we suspect that China's poor economic performance has undermined the EZ's productivity recovery due to the close economic link between the two. For whatever the reason, a lack of productivity growth is a serious problem for most economies across Europe.

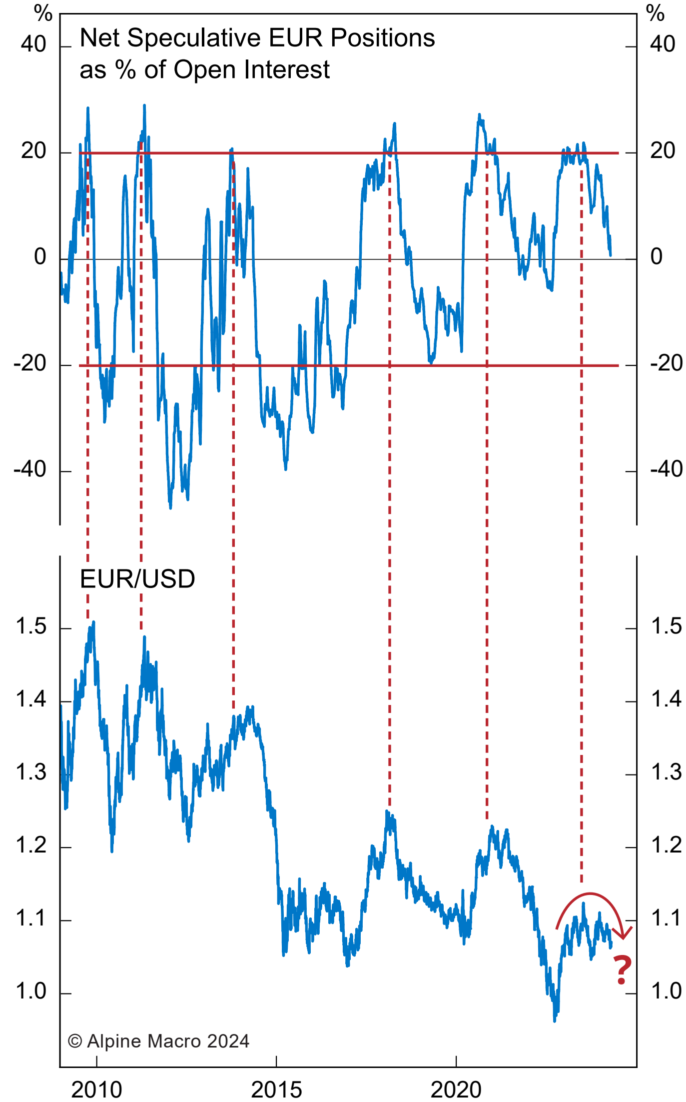
The key point is that, without finding a way to raise labor productivity, the EZ economy will continue to shrink relative to the rest of the world, with diminishing political and geopolitical clout. The living standards for Europeans will also become stagnant, creating social tensions and fermenting political extremism.

Third, a shrinking population tends to make the underlying economy susceptible to price declines. This is because population growth ultimately determines the natural rate of domestic demand growth. When the overall population stops growing, so does domestic demand and desired investment. This often takes place in an aging society where savings outgrow desired investment, which is another way of saying oversupply and its resulting price deflation.

Chart 10 shows how Japan slipped into price deflation in the mid-1990s, followed by China in recent years. It should be noted that Japan's price levels rose sharply in 2013 and have spiked again since 2021. These spikes are only mirror images of massive drops in the yen during these two periods rather than a reflection of strong demand.

Adjusted for a 50% fall in the JPY from late 2012 through 2014 and a 30% decline since early 2021, Japan's CPI would have fallen, given constant price elasticity to foreign exchange rate fluctuations. All this to say, while the ECB's current problem is inflation, one should be mindful of the underlying deflationary tendencies of the EZ economy.

Chart 11 Speculators Are Neutral On Euro



Strategy Toward Euro And Bunds

At present, the euro is probably undervalued by 10%, based on our PPP model. Nevertheless, valuation is a poor timing tool for market turning points. At present, net speculative positions in the marketplace are still mildly long the euro, suggesting downward pressure on the euro could still accumulate (**Chart 11**).

Chart 12 The Case For Bunds To Outperform

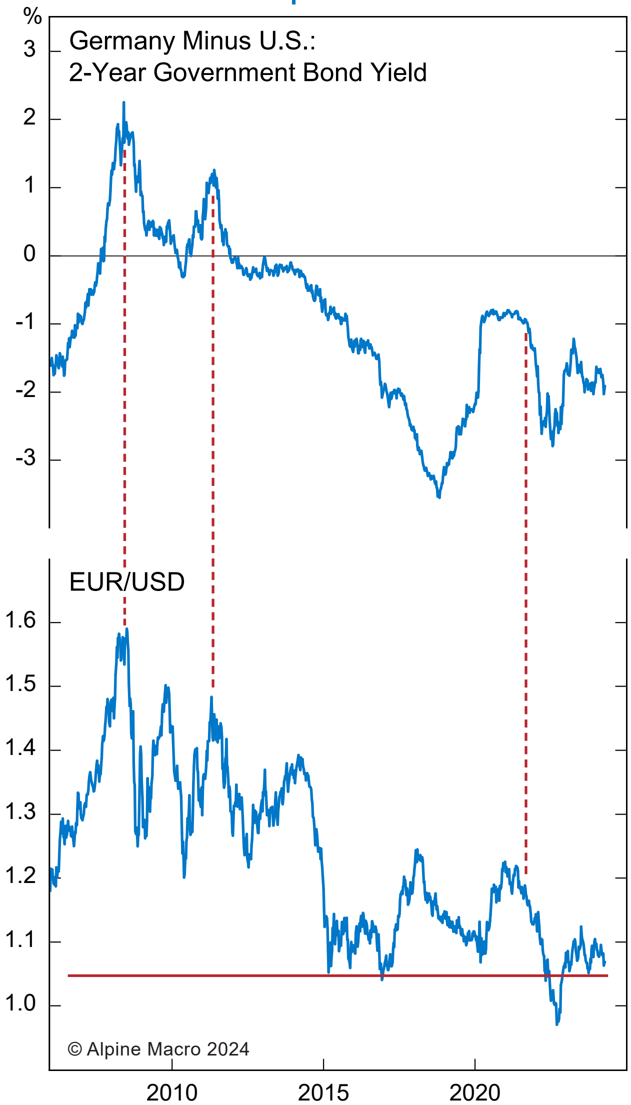
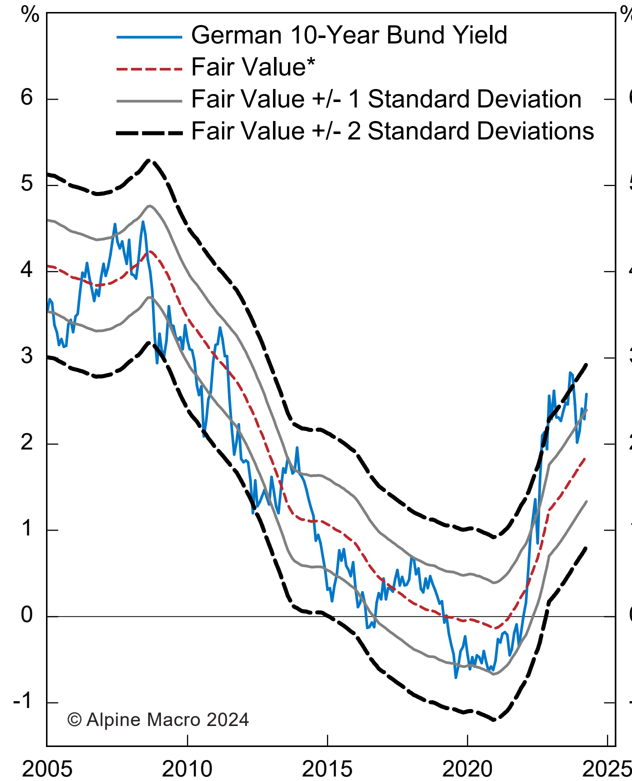


Chart 13 Fair Value Estimate For German Bunds



*Based on trends of inflation, short-term interest rates and unemployment rate

Moreover, investors are paid to short the euro versus the dollar, and the spread will likely become even more favorable for short sellers as the ECB cuts rates, while the Fed holds rates steady. The huge carry cost will make any durable rally in the euro difficult to come by.

Chart 12 shows that German bunds are often negatively correlated with the euro – a fall in the euro is often accompanied by a fall in bund yields. This makes sense because foreign exchange rates and interest rates usually move in tandem, as they are driven by similar economic forces.

How low can 10-year bund yields go? At present, the TIPS yield for 10-year bunds is 0.39%, which implies an inflation "breakeven" rate of 2.2%. The problem is that inflation has never stayed at that level, and our concern is that inflation could drop to levels way below 2% before year-end. In this case, bunds could rally a lot.

A few other considerations:

- **Chart 13** is our estimate of "fair value" for 10-year bunds. The key variables here are a lagging policy rate plus inflation. For the time being, it seems that bunds are 1.5 sigma oversold.

- The 10-2 year spread is deeply inverted (**Chart 14**), highlighting the ECB's extremely restrictive policy stance. Buying steepeners could be profitable as the ECB will be under pressure to ease.

- The Italian-German 10-year spread has tightened significantly but still has some room to go. The bottom panel of **Chart 14** shows that 100 basis points seems to be the hard limit of how tight the spread can go. At present, the spread is at 140 basis points, suggesting a potential compression of 40 basis points.

- Short EUR/USD.

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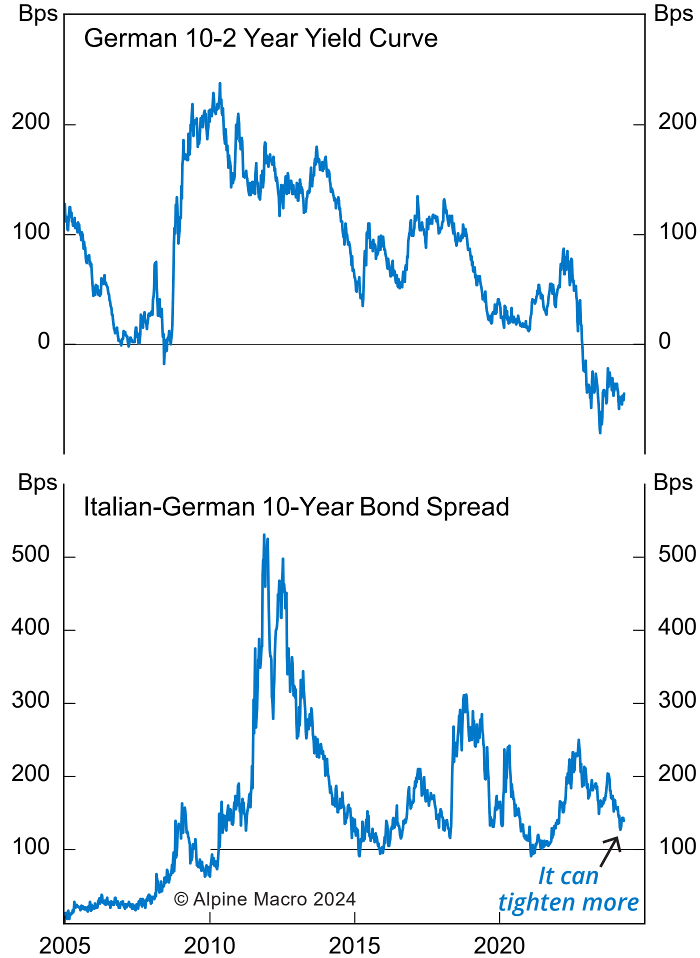
Chart 14 Some Important Spreads



A Unique Mind On The Markets