ECONOMICS: EUROPEAN PERSPECTIVES—JANUARY 29, 2010

Weak Periphery Hits the Euro

- **Darren Williams**
  Senior European Economist—Global Economic Research

The Greek crisis has pushed the euro to its lowest levels for several months. But the euro still looks overvalued and, with interest rate differentials set to move against it, we anticipate further weakness. Problems on the periphery merely add to the downside risks.

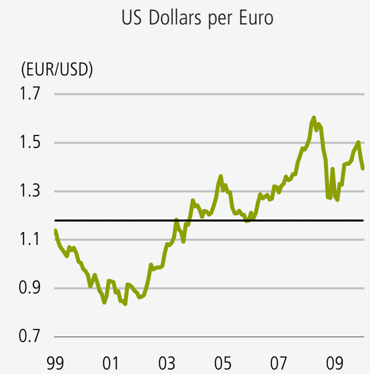
The euro has come under heavy pressure in recent weeks and is currently trading below 1.40 against the dollar for the first time since July last year **(Display 1)**. This weakness has, in large part, been driven by mounting concern about the outlook for countries on the euro-area periphery, particularly Greece. In our view, this has merely accelerated the euro's retreat from levels that are hard to justify on fundamental grounds. We think the euro has further to fall and maintain our long-held target of 1.30 against the dollar.

One of the first ports of call when trying to determine the outlook for an exchange rate is to establish an estimate for fair value. This, in itself, is an imprecise science. Over the years, however, we have found that real exchange rates can be a very useful guide. In **Display 2**, we show the euro's real exchange rate against the dollar and on a trade-weighted basis over the last 30 years. Following its recent fall, the euro is still 10% above its long-term average in trade-weighted terms, and almost 20% above its long-term average against the dollar. To put this in perspective, the euro would have to drop to 1.20 in order to eliminate its misalignment against the dollar.

But even if these estimates do represent fair value for the euro, it is important to recognize that currencies can remain dislocated from equilibrium for extended periods of time. For example, since the creation of the euro in January 1999, it has fluctuated between 0.84 and 1.60 against the dollar. Moreover, it has spent less than 40% of this period within 10% of its long-run average.

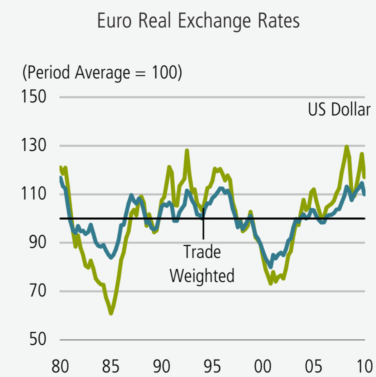
The problem, in the euro's case, is that it's hard to find compelling reasons for it to continue trading so far above its long-run average. It's true that short-term interest rate differentials currently favor the euro, but this is no longer true further out along the yield curve **(Display 3)**. Moreover, with the euro area likely to lag the US during the recovery phase of the business cycle, we think it's only a matter of time before short-rate differentials also begin to favor

Display 1
Euro Starts to Retreat



Source: Bloomberg, Haver Analytics and AllianceBernstein

Display 2
Euro Still Looks Overvalued



Deflated using whole-economy unit labor costs
Source: European Commission, Haver Analytics and AllianceBernstein

the dollar.

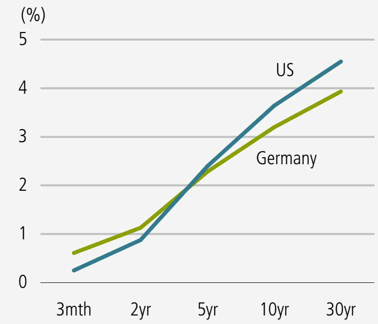
Our current expectation is that US interest rates will start to rise in the second quarter. In the euro area, by contrast, we think the timing of the first rate increase is slipping back. There are two main reasons for this. First, despite ongoing gains in survey data, recent hard data in the euro area have been disappointing—especially indications that German fourth-quarter GDP growth could be flat. While this continues, the European Central Bank (ECB) is likely to view the recovery as patchy, thus damping enthusiasm for an early rate hike. Second, in response to the Greek crisis, some euro-area countries are considering additional budget cuts. This could lower aggregate euro-area growth.

We now expect the ECB to raise interest rates by just 50 basis points this year and that any tightening will not start until late in the third quarter. This would put the refinancing rate at 1.5% by December, which is 50 basis points lower than our expectation for the federal funds rate. Without support from interest rates, and with problems on the periphery likely to reverberate for some time, it is difficult to see how the euro can sustain its current levels against the US dollar. ■

Display 3

Short Rates Favor the Euro . . . for Now

Germany and US Yield Curves



Source: Bloomberg and AllianceBernstein

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

Note to Canadian Readers:
AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

Note to UK Readers:
UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Taiwan Readers:
This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

Note to Singapore Readers:
This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers:
This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.