ET THE ECONOMIC TIMES

Aug 26, 2022

Where does the Euro (and Europe) go from here?

Synopsis

As a result, the Bank of England itself projects inflation to hit a peak of 13% in 2022, with some estimates even hitting 15% year on year (YoY). Cost of living is rising across the Euro area, which will only get worse with winter energy needs. Surveys indicate that people are already missing meals in order to make ends meet, with even some related suicides reported.

Devina Mehra

Chairperson and Managing Director, First Global

Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

First Global has since become a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds.

She has been quoted widely on Global as well as Indian markets by global financial media like Wall Street Journal, Barron's, Business Week, Fortune, Forbes, CNBC, Financial Times etc.

She tweets @devinamehra and the website is firstglobalsec.com

The Euro has been depreciating against the USD, starting the year at 1.2 USD to Euro to around parity now - a level last seen around 2 decades ago.

The question now: Where is the European economy and the Euro headed from hereon?

First, the energy crisis. Because that's at the core of what has been ailing the Euro area.

The energy situation that was bad last winter, has only worsened since the Ukraine invasion and is now being exacerbated by climate change issues. Benchmark gas futures are up 13 times since the beginning of 2021!

Germany 1-year forward baseload electricity has surged above 400 euros per MWh for the first time ever - about 10 times the 2010-20 average of €41.1 per MWh. In the UK, the 'default tariff cap' – widely called the energy price cap is headed for more than a doubling in 9 months, from April 2022 to January 2023.

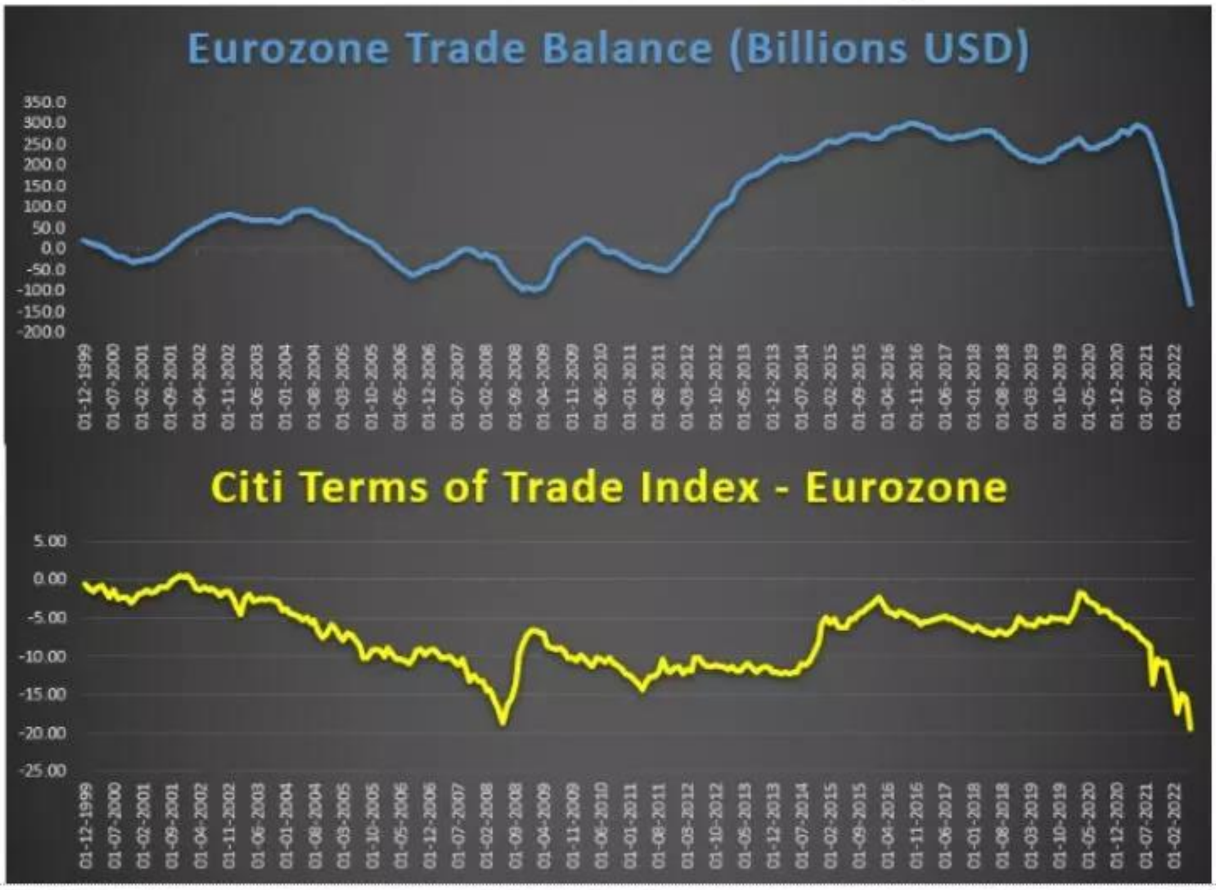
As a result, the Bank of England itself projects inflation to hit a peak of 13% in 2022, with some estimates even hitting 15% year on year (YoY). Cost of living is rising across the Euro area, which will only get worse with winter energy needs. Surveys indicate that people are already missing meals in order to make ends meet, with even some related suicides reported.

The energy issues have also made industry less competitive. In Germany, producer prices surge 5.3% month on month (highest on record) and 37% YoY.

Now for the climate impact. Europe's hot, dry summer means that major rivers have dried up. Water levels on the Rhine, Western Europe's most important waterway, is at a record low, making it too shallow for many ships to pass — a problem for Germany that depends on the river for 80% of its water freight.

These factors have wiped out the entire Euro Area trade surplus and pushed it into a negative territory. Meanwhile, the terms of trade for the Eurozone have plunged to a record low which doesn't bode well for the currency.

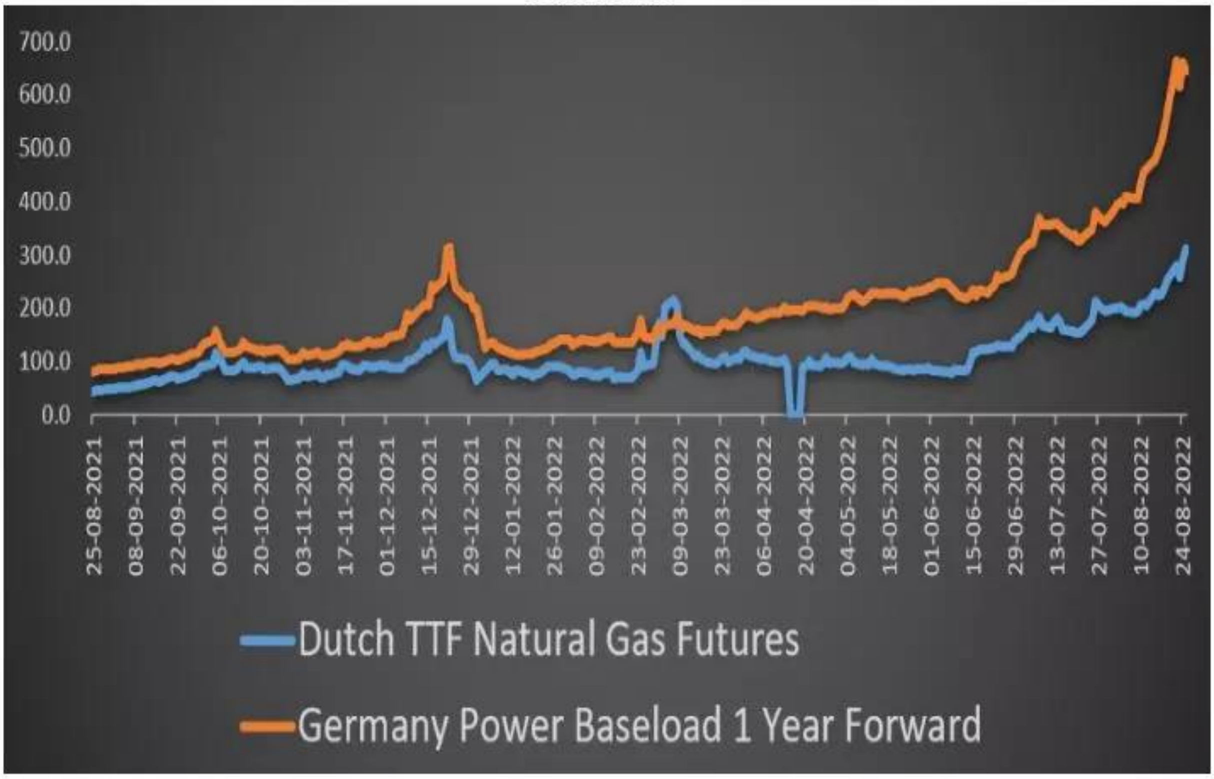
Eurozone Trade Balance & Terms of Trade Collapse



Source: Bloomberg

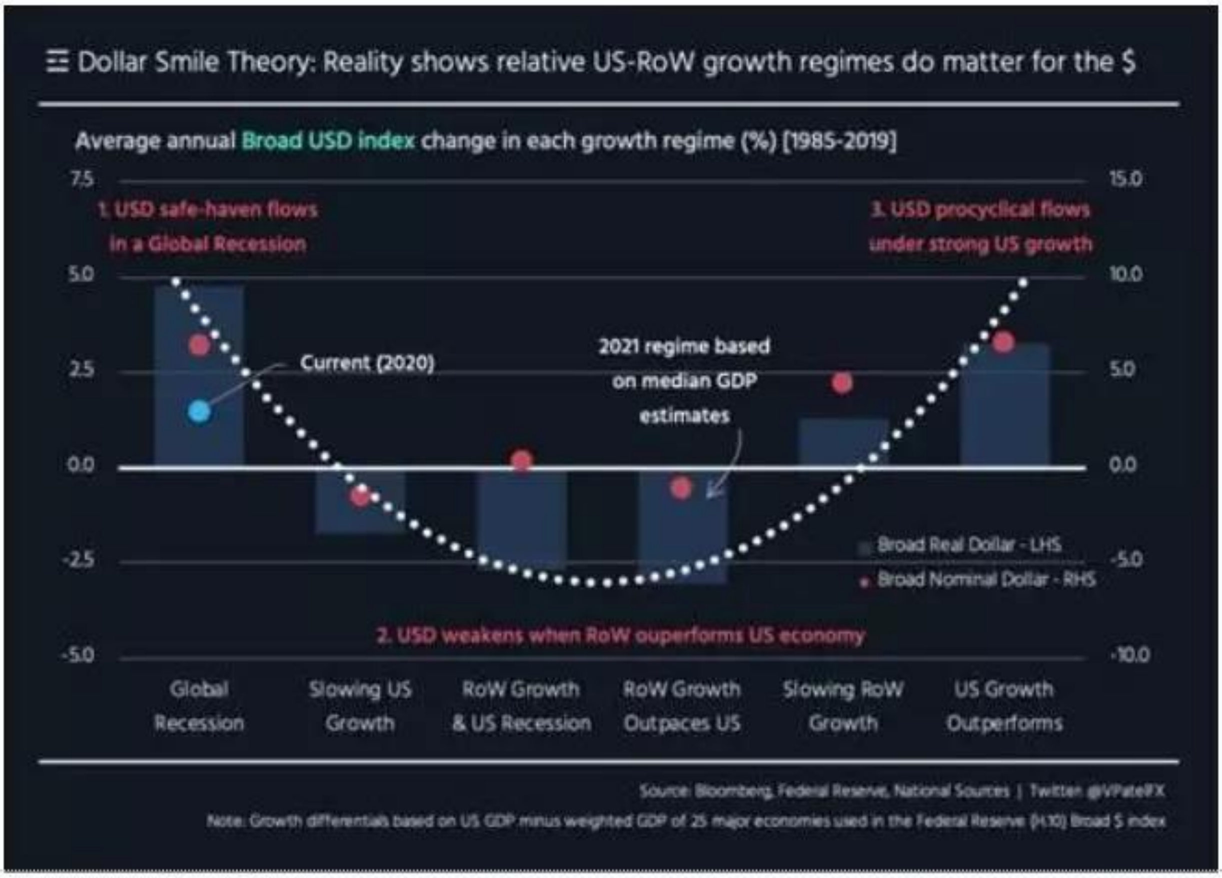
Given the pain in the economies, a very aggressive tightening by the European Central Bank (ECB) cannot be expected. Contrasted with the aggressive rate hikes by the US Federal Reserve (Fed), this will also cause pressure on the Euro.

Cost of Living Crisis: Benchmark European Gas & German Electricity Prices Go Parabolic



Source: Bloomberg

In an alternate scenario where energy prices do cool, relieving some pressure from the EUR, the incentive for the ECB to hike aggressively will be much lower relative to the US Fed given the difference in core inflation across US & Europe, thus still favouring USD from an interest rate differential perspective.



Source: Bloomberg

Finally, the well-known "Dollar Smile Theory" also remains in favour of the US dollar in the short to medium term. The Dollar Smile Theory states that in period of global recession and period of US growth being stronger than Rest of the World (RoW) growth, the US dollar outperforms and vice versa.

Hence, in the near term, the European economies will be the laggards in the terms of growth. The Euro appreciating against the dollar appears unlikely as of now. Of course, from a longer term perspective, things could change.

(Analysts Kavita Thomas and Harsh Shivlani also contributed to this piece)

(Disclaimer: The opinions expressed in this column are that of the writer. The facts and opinions expressed here do not reflect the views of www.economictimes.com.)