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Global

FX Insight

EUR - Cautious but Retain Medium Term Constructive Bias

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Cautious Outlook on EUR over Next 2 -3 Months

Recent EUR's decline was due to fresh concerns with Turkey (EU banks' exposure to Turkey given rapid decline in TRY, EU migrant issues, etc.), ongoing concerns with Italy's budget amid a negative carry environment (ECB-Fed policy divergence), amplified by a general risk-off tone.

We do not rule out near term bounce in the EUR, given some market stabilisation measures in Turkey to stem the rout on its currency. However a cautious outlook on the EUR is warranted over the next 2-3 months given uncertainty on Italy's budget plans (Sept) and German Bavarian State election (in Oct). We retain a constructive outlook in the medium term as the above-mentioned political concerns dissipate while ECB-Fed policy divergence slow and possibly converge at some stage.

Some Signs that Measures are Working But Economic Plan Needed

The more than 2% decline in the EUR/USD (partially triggered by the rise in geopolitical tensions between US and Turkey) since last Thu appears to show tentative signs of slowing. This comes amid slowing pace of depreciation pressure on the Turkish Lira (TRY) after the Central Bank of the Republic of Turkey (CBRT) introduced measures aimed at supporting financial stability and to sustain the effective function of markets yesterday (13 Aug).

Some of these measures introduced include lowering of Lira reserve requirement ratios by 250bps for all maturities while reserve requirement ratios for non-core FX liabilities were lowered by 400bps. The maximum average maintenance facility for FX liabilities has been raised to 8%. In addition to USD, the Euro can be used for the maintenance against TRY reserves under the reserve option mechanism. The CBRT also pledged to provide "all the liquidity the banks need" and for days with relatively higher funding need, more than 1 repo auction of maturities between 6 and 10 days may be conducted.

USDTRY (1 Minute Chart): 5% Gains in TRY vs. USD Today

Source: Bloomberg, Maybank FX Research & Strategy

It remains too soon to conclude that these measures introduced were successful. In the interim, we think these measures may temporary help to stabilize sentiment in the currency but **markets will be looking for more concrete plans to rebalance the economy. Failure to produce a follow-up economic plan in coming days could nullify the market stabilisation measures introduced by CBRT and the TRY could well come under pressure again. This would then have negative impact on the EUR**.

Macroeconomic Concerns in Turkey Need to Be Tackled

Taking stock, the TRY has been the worst performing currency this year, falling by about 80% vs. the USD (at one stage on Monday) and about 30% in the past few days. Turkey's economy faces very challenging issues on both the economic and political fronts. Turkey is running twin deficits of current account of -6.3% of GDP and a budget deficit of -1.6% of GDP, combined with high levels of debt in the private sector at about 170% of GDP and relatively high levels of external debt to GDP at 53%. According to IMF estimation, over a third of that is due this year while 40% is in floating rate debt, potentially resulting in higher burden as interest rate rises. Not forgetting that Turkey has relatively low FX reserves of about US$81bn, making it vulnerable to speculative attacks while the sharp depreciation in the currency this year has resulted in inflation running at about 16% and this may possibly rise further in the months ahead.

Falling FX Reserves - TRY Vulnerable to Speculative Attacks

Source: Bloomberg, Maybank FX Research & Strategy

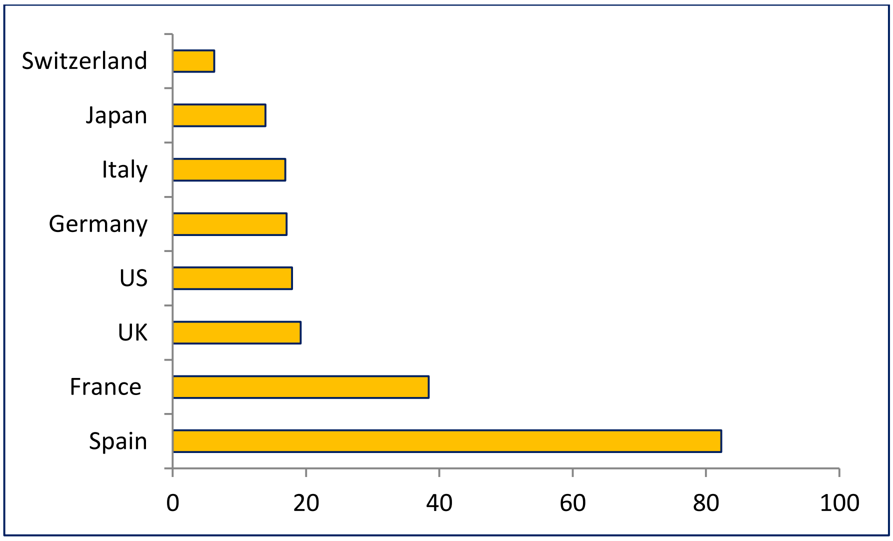
The Trigger for Sharp Depreciation in the TRY Late Last Week

The latest rout was due to Trump's tweets to double import tariffs on Turkish steel and aluminum to 50% and 20%, respectively, following US sanctions against 2 Turkish Ministers last Fri over Turkey's detention of an American pastor Andrew Brunson. The pastor is facing espionage and terrorism allegations following the failed 2016 coup and his case has been taken up by religious conservatives in the US. Basically the lack of resolve between US and Turkey (White House National Security Adviser John Bolton reportedly said that US has nothing further to negotiate until pastor is freed) and the lack of confidence in concrete plans to stabilize Turkey's economy are basically keeping the Lira and Turkish debt suppressed. Some diplomacy or conciliatory tone may have helped with sentiment but the Turkish President has instead shown defiance and is confrontational in his tone. He has also not shown any intent of seeking help from international community or IMF and the CBRT (central bank of Republic of Turkey) has not expressed any intent to raise interest rate. There are also concerns of political interference with the independence of Turkey Central Bank.

Fresh Concerns with Turkey Added to EUR's Woes

The rapid decline in TRY has led to ECB officials flagging concerns of European banks' exposure to Turkey. According to BIS report (end-Jun 2018), Spanish banks have the highest exposure to Turkish borrowers at US$83bn, French banks are owed US$38bn, UK banks are owed US$19bn, Italy and German banks are each owed US$17bn. Concerns remain over Turkish borrowers' ability to meet debt obligation or if European banks stop rolling over the loans resulting in defaults and this could eventually impact European banks' stability.

European Banks' Debt Exposure to Turkey (in US$ bn)



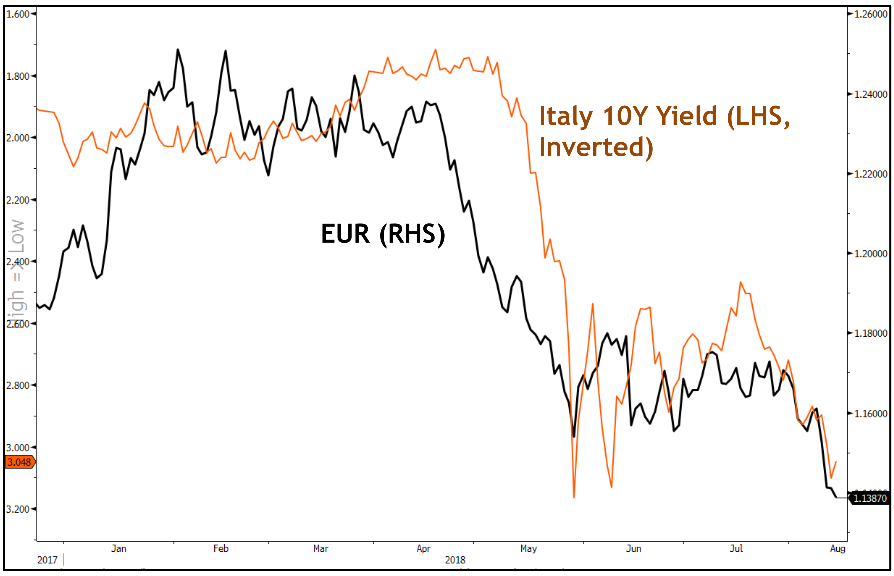
Note: Based on amount outstanding on claims on an immediate counterparty basis for 1Q 2018 (latest available)
Source: BIS Consolidated Banking Statistics last updated Jul 2019 (Table B4), Maybank FX Research & Strategy

It is important to note that Europe relies on Turkey to contain the flow of migrants trying to reach Europe. If Turkey economy heads for a hard landing, the EU could face the risk of migrants resurging again as Turks may prioritize other economic issues. Already the number of migrants trying to reach Europe from Turkey has risen to 14,000 YTD Jul 2017, up from 9,152 in the same period last year. This could complicate the political situation in Europe as the rise in populist parties (far right) have been using the migration issue (amongst others) to win votes in recent elections. Recall how Germany's Alternative for Germany (AfD) party won 12.6% of the votes in German Federal election and entered the Bundestag with 94 seats and most recently in Mar 2018, anti-immigrant League and anti-establishment 5 Star Movement (5SM) formed the coalition government in Italy. Oct 14 brings German Bavarian State election, German Chancellor Merkel is at risk of losing powers if Christian Social Union (or CSU, the sister party to Merkel's CDU party and coalition partner) loses the election to right wing AfD. Rise in populism undermines the Euro-club; heightens political uncertainty and this may pose downside pressure on the EUR.

Concerns with Italy Debt Weigh on EUR

Apart from negative repercussion from Turkey weighing on the EUR, Europe is not without its own troubles. Concerns remain over Italy's 2019 budget plans. Local media reported that government may set 2019 deficit to GDP at -1.7 to -1.8%, much higher than the target of -0.9% set by previous administration. Given that the coalition government may push on with planned reforms that could cost more than EUR100bn (Five Star Movement is pushing for citizen income while League is proposing flat tax and to impose immigration limits) and boost spending (demand for funds), coinciding with September which is typically the busiest month for new bond sales in Europe, Italian bond yields could remain supported or even rise further. EUR's negative correlation with Italian yields has strengthened since Mar this year. Further rise in Italian bond yields (inverted on the chart below) or widening credit spreads may add to further downward pressure on EUR.

Concerns in Italy Budget Add to EUR Downside Pressure



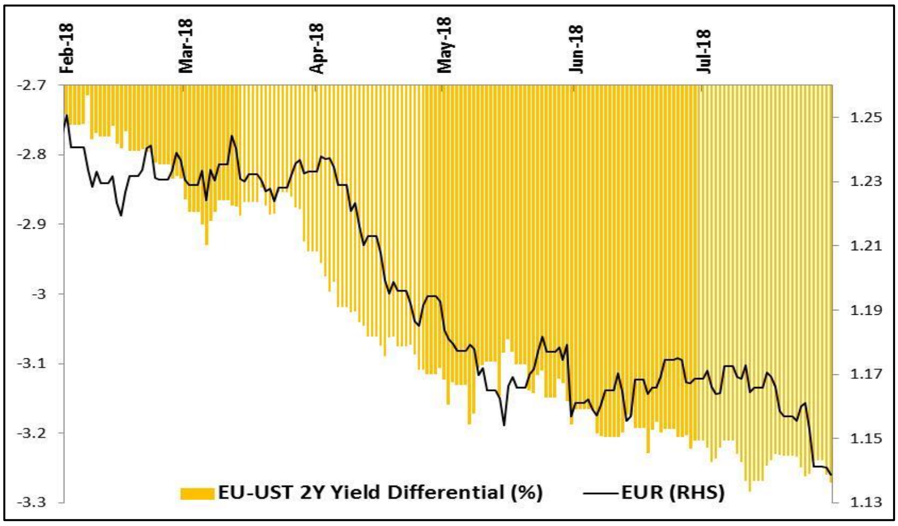
Source: Bloomberg, Maybank FX Research & Strategy

Some dates to keep in view include end-Aug/early Sept when Italy's economic and financial plans will be presented; new public finance targets to be set by 30 Sep; draft Italy budget to be submitted to the EU for review by 15 Oct. The final budget has to be ratified by Italian parliament by end-2018.

ECB-Fed Policy Divergence Still Weigh on EUR

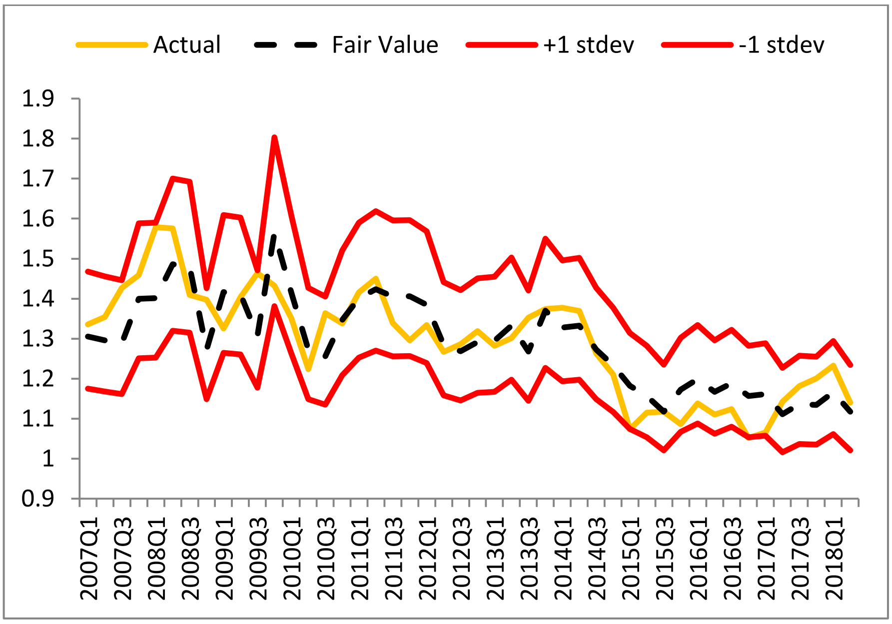
Though we expect ECB-Fed policy convergence to happen at some stage, the current environment is still being driven by ECB-Fed policy divergence. 2Y yield differentials between EU bonds and USTs are nearly -330bps and ECB President Draghi's commitment to keep ECB key interest rates at their present levels at least through the summer of 2019 could keep the policy divergence thematic intact for now.

EUR Remains under Pressure amid Negative Carry Environment



Source: Bloomberg, Maybank FX Research & Strategy

EUR Fair Value at Around 1.12 Levels



Source: CEIC, Bloomberg, Eviews, Maybank FX Research & Strategy

Our fair value model (estimated using OLS on quarterly data starting 1Q 2007) which takes into account 3 cyclical factors - the 10Y yield differentials between EU and US adjusted for inflation, current account to GDP ratio differentials and a reflation variable (proxy by changes in World equities to World Government bond) puts EUR/USD fair value estimate at 1.12 levels, with a lower bound of 1.02 and 1.23 (1 standard deviation from fair value estimate). This implies that current level of spot remains well within our fair value estimate range; deviation from the fair value point estimate is not uncommon.

Extending Our Thoughts onto AXJ and Antipodean FX

Trade war between US and China as well as geopolitical tensions between US and Turkey are double whammies for AXJ FX. Recent Lira rout should weigh on twin deficit currencies in the region including IDR, PHP and INR. High beta currencies such as KRW and TWD may also be negatively impacted given the sell-off in equities amid risk off sentiment. Trade war between US and China are far from over - China has responded last week to impose 25% tariff on $16bn US imports wef 23 Aug while US public hearing (20 – 23 Aug) on another round of tariffs on $200bn of imports from China may attract another round of tit for tat response from China. Some of the currencies that are vulnerable to CNH selloff include KRW, SGD, AUD, and NZD. Latest development remains consistent with our call to buy USD/AXJ on dips.

EUR (Weekly Chart): Cautious

Source: Bloomberg, Maybank FX Research & Strategy

EURUSD was last seen at 1.1390 levels. Bearish momentum on daily and weekly charts remains intact while stochastics has fallen into oversold conditions. Rebound risks not ruled out in the interim. Resistance levels at 1.1450, 1.1510 levels. Failure to retake those levels could see bears re-assert. Support at 1.1360, 1.1320 and 1.1190 (61.8% fibo retracement of 2017 low to 2018 high).

EURSGD (chart on page 7) was last seen at 1.5660 levels. Bearish momentum on daily chart remains intact but stochastics is entering oversold conditions. Immediate support at 1.5630 (50% fibo retracement of 2017 low to 2018 high, upward-sloping trend-line support from the lows in 2017 and 2018) before 1.5550 levels. Break below these levels open way for further downside towards 1.5430 (61.8% fibo) levels. Resistance at 1.5820 (38.2% fibo). Bias to buy the cross on dips.

EURSGD (Weekly Chart): Nearing 1.55 - 1.56 Support

Source: Bloomberg, Maybank FX Research & Strategy

EURMYR (Daily Chart): Bearish but Nearing Oversold Conditions

Source: Bloomberg, Maybank FX Research & Strategy

EURMYR was last seen at 4.6650 levels. Bearish momentum on weekly and daily charts remains intact. Support at 4.6620 (61.8% fibo retracement of 2016 low to 2017 high) before 4.6240 (upward sloping trend-line support from the lows of 2016 and 2018). Stochastics at oversold conditions on the daily chart may suggest rebound risks in the horizon. Resistance at 4.7060 (50 DMA), 4.7560 (50% fibo).

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