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Aerial View

Morning Briefing

Nov 11, 2020

Euro Carry Hope on Vaccine

- **Europe's reflation hopes recover on vaccine optimism**
- **Likely early deployment of fiscal will contain economic scarring**
- **Despite spot moves, EUR carry interest not uniform**

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This week’s momentous news of a potentially successful vaccine for COVID-19 has triggered one of the biggest rotations in asset markets in recent memory.

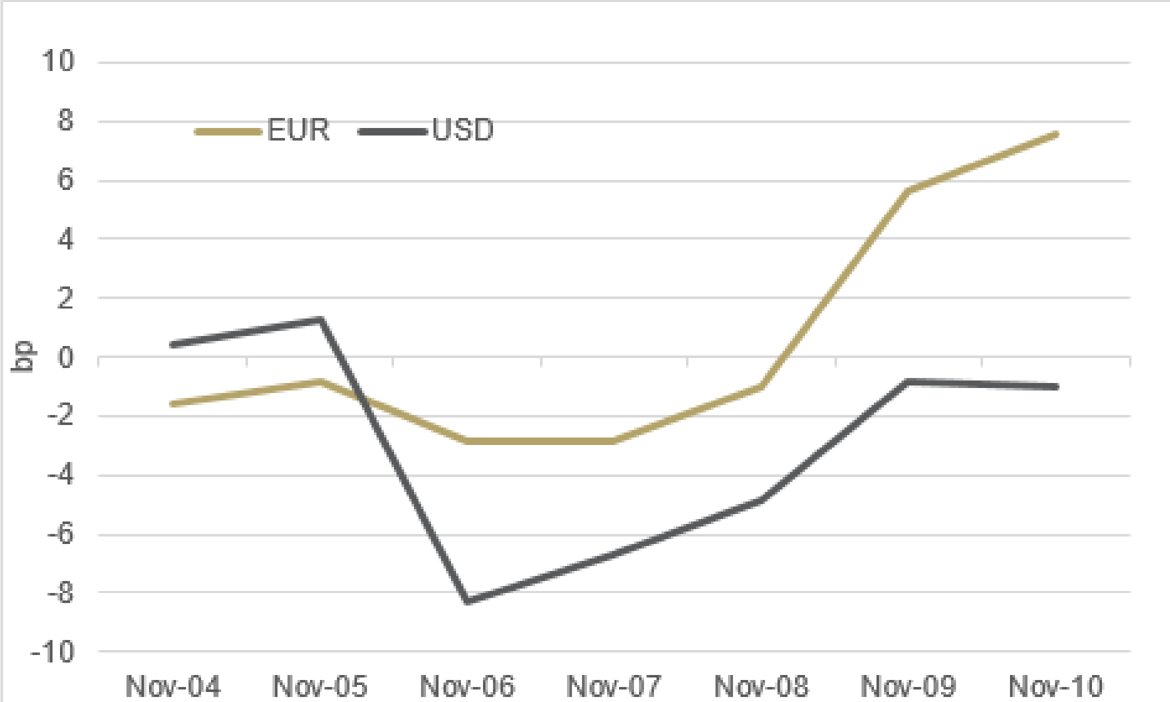
Unsurprisingly, the eurozone equities market has been a major beneficiary as its value heavy components finally found favor.

In hindsight, the moves have also revealed the extent of underweight positioning in eurozone assets. So far, the move has not extended materially into FX, but we do see prospects for this to change as Europe’s fiscal follow-through remains underappreciated by markets.

Since the vaccine news broke, eurozone inflation expectations have actually moved more than in the US. As the chart below shows, US 5y5y forward breakevens are actually still below levels seen just after the election.

It is true that eurozone inflation expectations are coming off a much lower base (exacerbated by lockdowns in Germany and France), giving them greater scope to move higher, but it is still the fiscal response that sets the eurozone apart from G5 counterparts.

Change in Inflation Expectations, Past Week



Source: BNY Mellon Markets, Bloomberg L.P.

Political responses on fiscal policy could not be more different on each side of the Atlantic.

While Senate Majority Leader Mitch McConnell saw the vaccine news as an opening to reduce the amount of stimulus which could be deployed, the eurozone has just overcome certain political hurdles to agree the Next Generation EU rescue fund and a multi-year budget to start deployment as soon as mid-next year.

The stated aim of spending 70% of the NGEU funding over the next two years remain in place and will go far in boosting the eurozone’s inflation and growth outlook, or at least ensuring that the 2021-2022 macroeconomic projections to be announced in December will not face serious downward revision.

The projections also have a very specific baseline assumption on a vaccine, whereas the ECB expects “a satisfactory medical solution (such as a vaccine) is assumed to be found by mid-2021, with a gradual widespread deployment by the end of 2021”.

Suffice to say the medical community is probably on track to meet, or even outperform, the baseline.

> ***The ECB expects "a satisfactory medical solution (such as a vaccine) to be found by mid-2021, with a gradual widespread deployment by the end of 2021"***

On the other hand, we do not see the vaccine news as changing the short-term path for the ECB.

The Governing Council was quite clear about the need for additional easing in response to the new lockdowns in Germany, France and elsewhere in Europe, which were also not part of its baseline assumption, which suggested that the spring lockdowns would not be repeated this winter.

Leading indicators, especially in the services sector, were already deteriorating heading into November, increasing the scope for economic scarring which needed to be offset through monetary and fiscal stimulus.

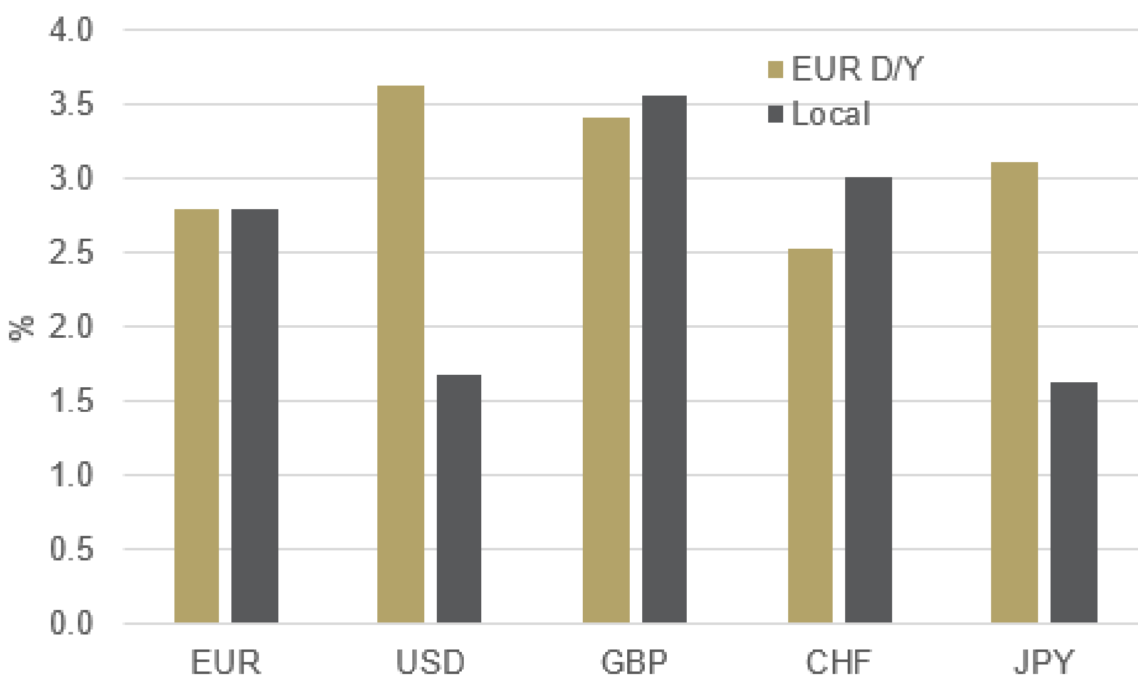
So far, the eurozone is the only major pandemic-affected economy where such stimulus has been sustained throughout lockdowns and in a consistent manner.
The US is no closer to a new dose of fiscal support, while the UK's initial piecemeal and latterly comprehensive extension to the furlough scheme has likely generated too much uncertainty for employers' liking.

Returning to asset markets, the euro is also starting to claw back attractiveness, especially in equity markets. The chart below shows European dividend yields hedged backed into local G5 currencies, measured against the dividend yield of local benchmarks. At 2.80% hedged, levels are already attractive on an outright basis.

For USD, GBP and JPY investors, hedging back into local currency will generate additional yield pickup due to favorable rate differentials. Dollar and yen investors can pick-up an additional 150-200bps through these strategies, and even GBP-based investors who traditionally enjoy high dividend yields via the FTSE100 can afford to give eurozone equities an additional glance.

The Swiss market remains the outlier, where both absolute dividend yields and rate differentials both work against such a strategy.

Eurozone Stoxx 600 Dividend Yield (Hedged) vs. Local Market Dividend Yield

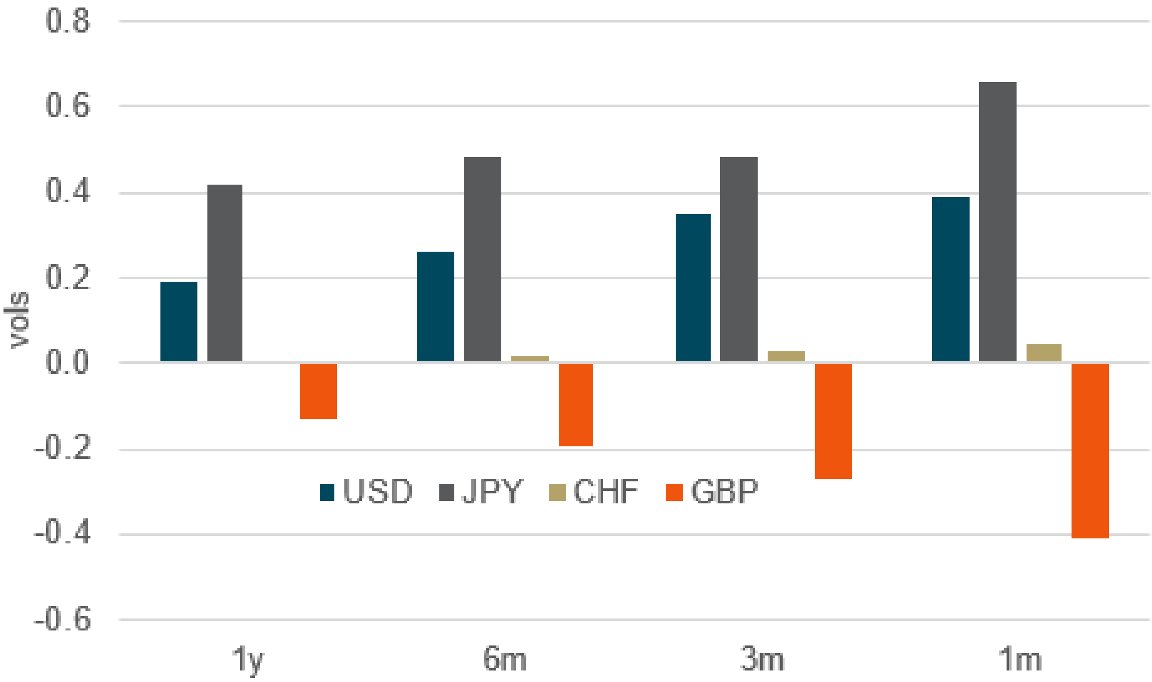


Source: BNY Mellon, Bloomberg LP

In euro currency pairs, the reaction has not been uniform either. We set aside initial spot movements and look at the options curve to see if there has been any fundamental shift in the euro's expectations.

As the chart below shows, in a manner consistent with the improvement in equity performance, risk reversals in EURUSD and EURJPY have moved materially across the term structure in favor of euro calls. However, EURCHF is unimpressed by recent developments and sterling seems to have achieved an even bigger bounce from vaccine news.

Change in EUR- Risk Reversals, Oct 30 - Nov 6



Source: BNY Mellon, Bloomberg LP

> ***EURCHF is unimpressed by recent developments and sterling seems to have achieved an even bigger bounce from vaccine news***

Much of the improvement in sterling demand also stems from a low growth/inflation base, while there may be some additional tailwinds from Brexit developments.

On the other hand, we believe the fiscal divergence between the UK and eurozone is continuing to widen and this will have a material impact on growth differentials in upcoming quarters.

In our previous notes we have highlighted how the eurozone continues to struggle with achieving credibility on reflation as the market always imposes a higher bar compared to economies with higher potential growth.

These are structural aspects which will take time to resolve, but we should not conflate these issues with the medium-term outlook, where the eurozone is far better positioned compared to its peers.

Please direct questions or comments to:

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