Is the Euro Ready to Bounce Back?

The euro hovered around US$1.25 at the beginning of the year, but had slid all the way down to US$1.13 by the end of October. A slight uptick has brought it up to just over US$1.14 in the past few days.

A resurgence of fears about the Italian debt was the main reason for the euro’s poor performance. Those fears, bolstered by the risk that the euro zone could break up, became evident in May when a coalition of two parties that are usually critical of European institutions came to power. They are Luigi Di Maio’s Five Star Movement and Matteo Salvini’s Northern League, both of which have agreed on a budget that contains additional expenditures and a higher deficit. The European Commission has not approved that budget, however, which means Italy now faces penalties as high as 0.5% of its GDP.

Apart from Italy, sluggish economic growth in the euro zone is also having a negative impact on the common currency. 2017 was a good year for the economy, which led the European Central Bank to reduce its asset purchases. These purchases should end in December, and a first hike of key interest rates is expected by the end of next summer. Many investors now think that scenario is less likely.

The protectionist threat from the United States is doing nothing to improve the situation. In addition to supporting the greenback against most other currencies, protectionist measures could further slow down European economic growth. That is particularly worrisome in Germany, where the mighty automobile industry may be up against new U.S. tariffs.

Other bad signs for the euro are the painful Brexit negotiations and greater volatility in the financial markets. The Brexit talks seem to be back on track now, which has helped the euro. As for market volatility, risk appetite remains low, which further benefit to the U.S. dollar.

**IMPLICATIONS**

We still believe the euro could hit US$1.16 by the end of the year, and it might even climb above US$1.20 by the end of 2019. That scenario is not altogether certain, though, and many things will have to improve, starting with the economic data. Confirmation of a Brexit agreement would be a step in the right direction, as would a decline in U.S. protectionist posturing. Investors might also increase their appetite for risk. It seems less likely that the Italian situation will be solved in the short term, however. Positive factors for the euro would be the European Commission taking a more conciliatory tone, or an openness to certain budgetary adjustments in Italy.

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