

---

## Market Environment For: Euro

---

### Summary

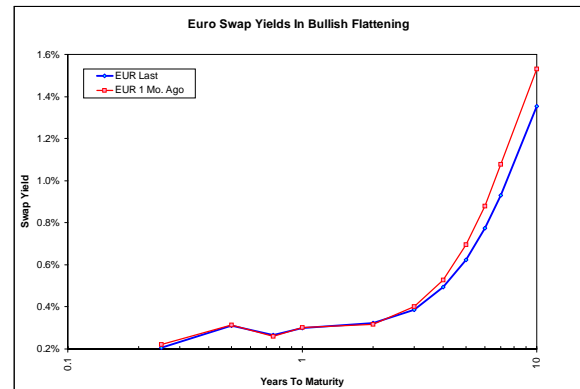
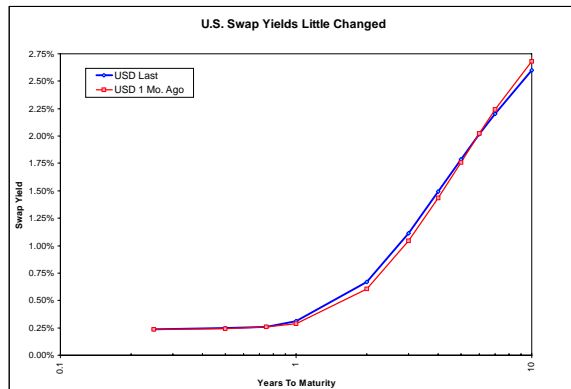
The EUR's downward bias from early May remains intact. Resistance is at 1.3600 with downside potential projecting to 1.3435 followed by 1.3300.

The balance of indicators is bearish for the EUR:

- Expected short-term interest rate differentials are moving in the USD's favor;
- Relative asset prices remain negative for the EUR; and
- Volatility indications are negative for the EUR

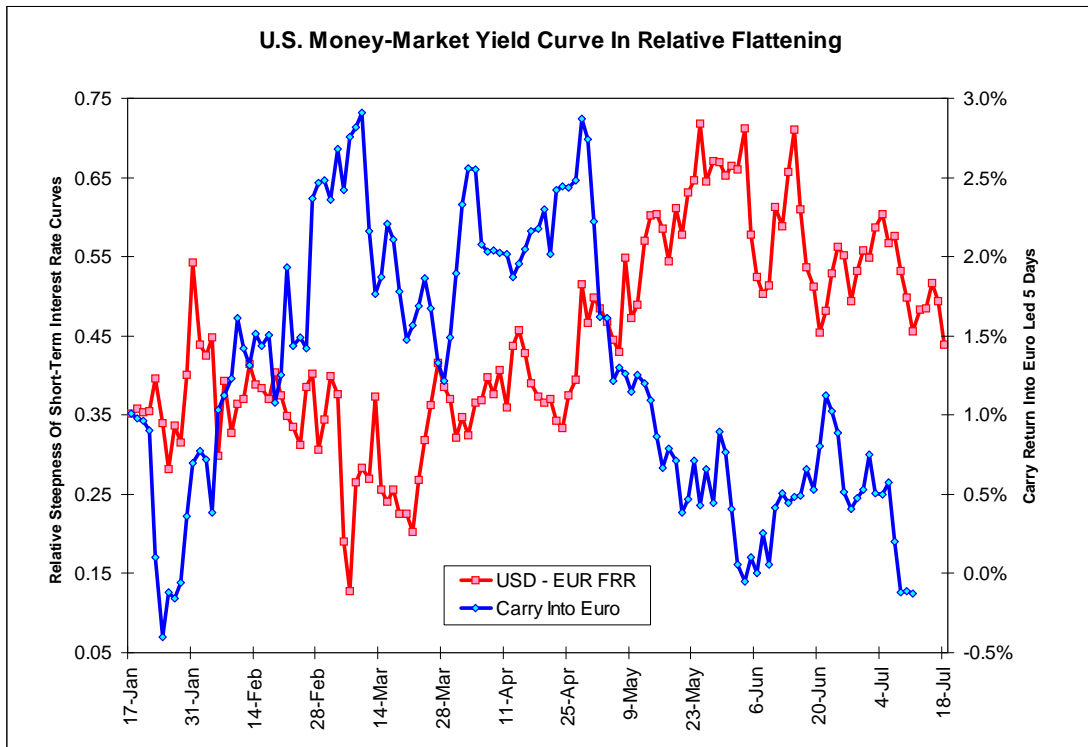
### Interest Rate Indications

U.S. swap rates in both the money-market and note-horizon segments have remained largely unchanged over the past month. EUR swap rates have moved in a modest bullish flattening. The absolute rap gap favors the USD.



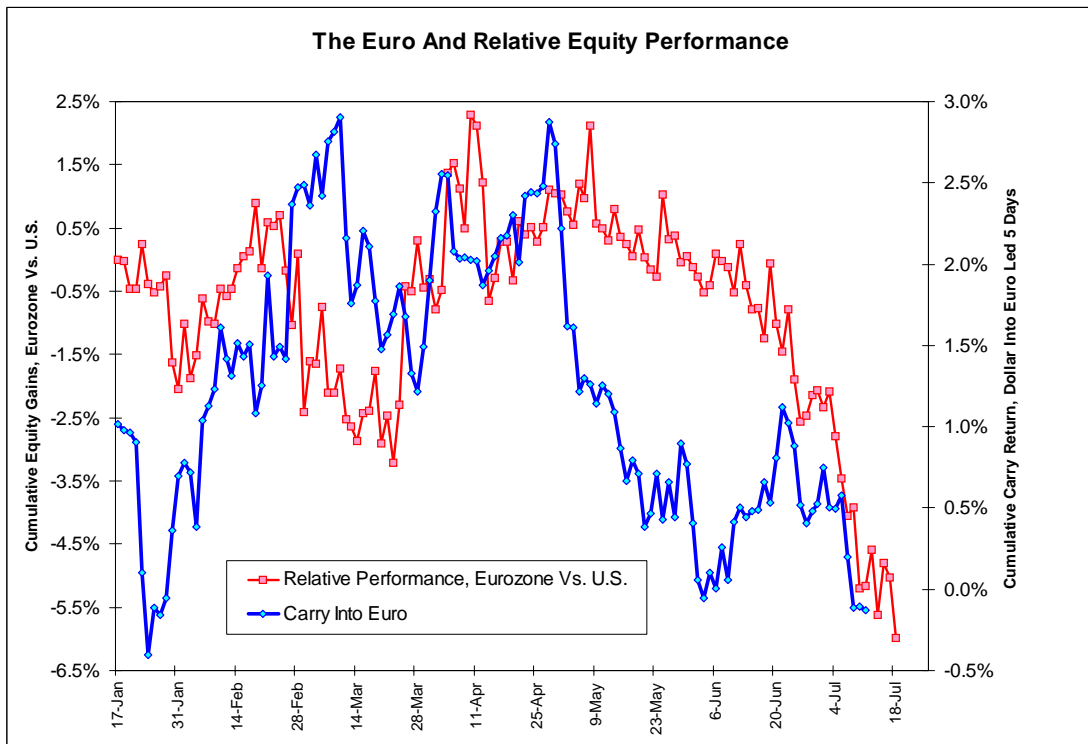
The combination of expected interest rate movements started to shift in favor of supporting the EUR at the start of February. This can be measured by the difference in forward rate ratios between six and nine months ( $FRR_{6,9}$ ) for the two currencies. These are the rates at which borrowing can be locked in for three months starting six months from now divided by the nine-month rate itself. The steeper the yield curve, the more the  $FRR_{6,9}$  exceeds 1.00. An inverted yield curve has an  $FRR_{6,9}$  less than 1.00.

The USD  $FRR_{6,9}$  is flattening vis-à-vis the EUR  $FRR_{6,9}$ . This means benchmark EUR short-term interest rates will “roll down” the yield curve more rapidly over the next three months when the time to roll a non-deliverable euro forward arrives than will USD rates. The opposite pattern had prevailed between March and May and had been supportive for the EUR. The chart below depicts this expected interest rate differential leading the dollar's carry into the euro by five days.



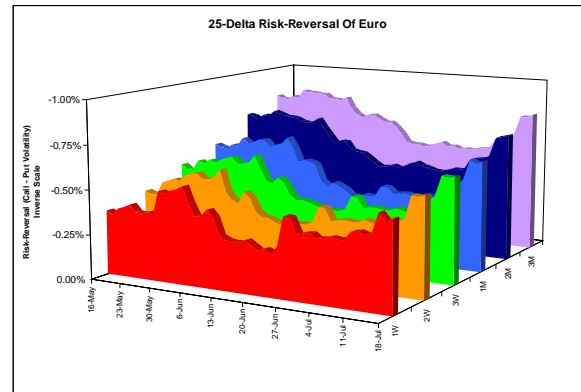
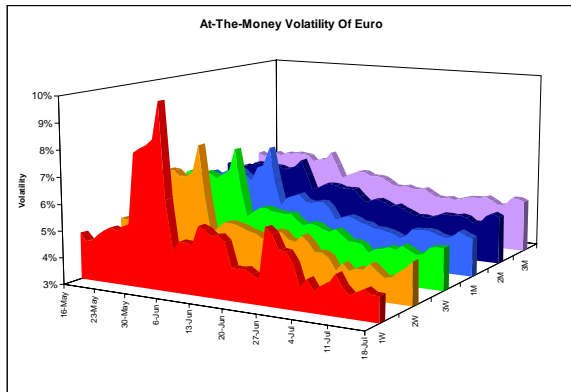
### Equity Indications

Capital inflows into European equities necessitate the purchase of EUR. The total return of Eurozone stocks relative to their U.S. counterparts has been declining since early May and accelerated with the recent jump in Portuguese banking risk and with last week events in Ukraine. The continued downtrend is negative for the EUR's direction. The chart below depicts this relative performance leading the dollar's carry into the euro by five days.



## Volatility Indications

The volatility of USD forwards for EUR holders tends to decline when traders get nervous about the EUR weakening. At-the-money volatilities rose slightly last week but the risk-reversal or difference between 25-delta call and put option volatility on the EUR forwards has turned lower (inverse scale) over the past three weeks. The balance of risks is for a weaker EUR.



The excess volatility of the USD for a EUR holder, or the ratio of its implied volatility to its realized volatility, minus 1.00, is rising (inverse scale). EUR-domiciled investors had been buying calls on the USD and puts on the EUR in bearish strategies.

