Euro poised for even bigger rally against the dollar, if past patterns hold

- After a two-year lag, the Eurozone economy is posed to outperform the U.S. relative to potential growth profiles over the coming several years.
- While Europeans look to make trade deals with Japan, China, and others, the U.S. is exiting or weakening existing trade deals, and delaying and/or scrapping others.

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An employee counts euros and U.S. dollar notes in a currency exchange store in Lisbon, Portugal.

The euro seems poised to rally to much higher levels against the U.S. dollar over the coming years, especially if history is any guide and forward macro-politics provide any impetus.

For the last two and a half years the dollar has traded in a tight range between 1.05 and 1.15 to the euro. I believe the recent breakout above 1.15 portends major upside for the euro.

Looking back over the longer term, the exchange rate exhibits significant multiyear cyclicality with strengthening and weakening legs that last six or more years.

That has happened in two past cycles and appears to be happening in the current cycle. Reconstructing the equivalent of the euro using a weighted basket of currencies prior to 2001 and the euro itself since then, we observe a relatively stable exchange rate. All three cycles begin with a period of dollar strength (lasting 6.25, 7.75, and 6.25 years, respectively).

In the first two cycles, the euro (or its equivalent) recovered all of its lost ground in the subsequent 7.25 and 7.75 years. With the third cycle half-complete, we may be in the early stages of a multiyear strengthening period for the euro.

During the first cycle, the dollar enjoyed years of strength thanks to then-Federal Reserve Chairman Paul Volcker's aggressive monetary tightening, collapsing inflation rates, and the resulting significant "real" yield advantages. Following the Plaza Accords of 1985 and the coordinated policy of dollar weakening, the euro equivalent appreciated into the recession of 1990-91 before peaking and completing the first cycle in 1992.

The dollar again appreciated in the first leg of the second cycle through 2000, on the back of higher productivity rates from the technology boom, which overwhelmed the positive effects of European interest rate convergences in anticipation of the introduction of the euro. The subsequent euro appreciation, which lasted into the financial crisis, owed much to the significant deterioration in the U.S. budget picture thanks to President George W. Bush's tax cuts, the post Sept. 11, 2001, increase in military spending and later the Federal Reserve's aggressive interest rate cuts early in the crisis.

The third cycle again started with dollar strength in 2009 and lasted into early this year as the U.S. economy outperformed a crisis-laden European economy that over that period had to deal with one shock after another, beginning with Greece's debt crisis and ultimately leading to Britain's vote to leave the European Union, or Brexit.

If we believe the dollar's strength and the first leg of the third cycle are over and a multiyear period of depreciation against the euro is upon us, what will be the main drivers of such an outcome? There are three:

Relative economic performance. The Eurozone economy is posed to outperform the U.S. relative to potential growth profiles over the coming several years. The zone is benefiting from a lag of nearly two years in its economic cycle and the catch-up momentum that comes with it. A convergence of not just GDP growth, but unemployment, business and consumer sentiment, and inflation should occur especially if the U.S. cycle turns the corner and begins to reverse.

Relative monetary policy. On par with the relative economic position, the Eurozone also lags the U.S. in its monetary policy stance, one which we believe will also see significant convergence over the coming several years as the U.S. reaches the end of its monetary tightening cycle simultaneous with the ECB being in the early stages of its tightening.

Relative stance on trade. While Europeans look to make trade deals with Japan, China, and others, and strengthen integration post Brexit, the U.S. is exiting or weakening existing trade deals, delaying and/or scrapping others, and either threatening to or imposing tariffs. A U.S. administration that increasingly views "fair trade" as "equal trade" and not "free trade," will need a weak dollar policy via the old tried and true method of "beggar-thy-neighbor" currency devaluation if it hopes to achieve a significant improvement in the trade balance over the near term.

While short-term technical point to a very over-bought euro exchange rate and the ebbs and flows of the markets will likely create some interesting volatility, the fundamentals point to continued and significant strengthening of the exchange rate over the coming years.

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