



outperformance precede dollar strength. The swing factor for a more pronounced dollar move, though, appears to be real interest rates. Their relentless decline since late 2008 did weigh on the dollar, but the picture has started to improve as real rates appear to be turning up (see first chart on this page). Earlier tapering by the Fed would likely cause a sharper move up in real yields, but even a further delay in tapering would unlikely cause real yields to reach new lows. Therefore, markets have entered an important new phase for the USD: real yields moving higher in tandem with stronger equity markets. Such a combination should be very supportive for the dollar. We therefore like to go long the dollar trade-weighted index.

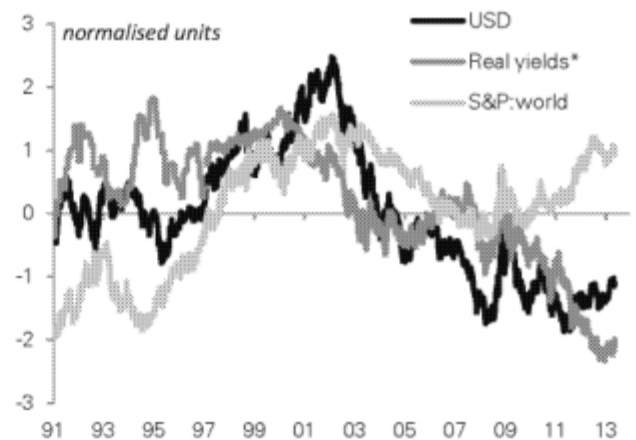
**What about the euro?**

We turned bearish EUR/USD at the beginning of March, and beyond our broad bullish dollar view we see two factors as driving us towards our 1.20 end-year target. First, we see divergence in conventional policy expectations (rates) returning. For all the unconventional measures since 2008, the remarkably consistent pricing of 2-year ahead rates paths from the Fed and ECB post Lehman is what stands out (see second chart). We think this year will mark the beginning of renewed divergence. On the Fed side, mid-2015 guidance is soon coming into view for 2-yr rates making the entire US yield curve "live". In contrast, the ECB is re-opening a discussion around negative rates and strengthening its verbal guidance on "low for long" via multi-year liquidity commitments. For how long can the market be pricing identical rates paths for the ECB and Fed over the next decade?

Second, and more importantly, we see the reduction of Eurozone risk premia as negative, not positive for the EUR. On the one hand, our models suggest there is little redenomination risk priced into the EUR anymore. This has seen the correlation with Euro peripheral bond spreads and EUR/USD drop to close to zero, and makes the potential (negative) EUR/USD reaction to a return of tail risk very asymmetric. Most importantly, the big story over the last five years has not been a lack of inflows into the Euro-area, which have remained remarkably steady. It has been domestic risk aversion. This has seen large waves of repatriation and the building of more than EUR 1trillion worth of underweights in foreign assets. Lower tail risks and a gradually improving business cycle should see a return of these outflows - so we think EUR/USD is fully capable of participating in a USD rally, even if it lags the move lower in many other crosses.

Bilal Hafeez + [REDACTED]  
 George Saravelos + [REDACTED]

Figure 4: USD Drivers Turning Up



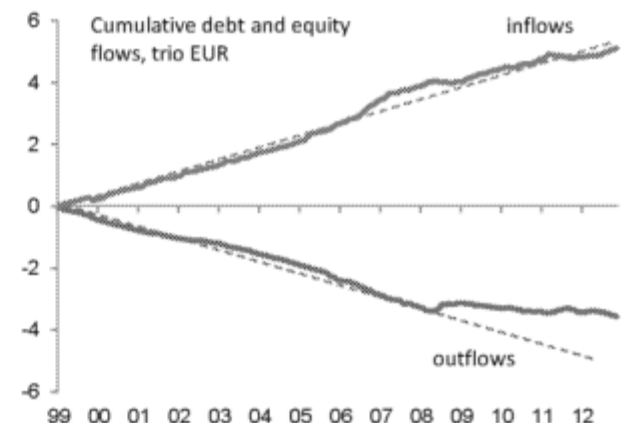
Source: Deutsche Bank, \* pre-1997 nominal 10y minus CPI used, rather than TIPS

Figure 5: ECB To Diverge From Fed



Source: Deutsche Bank

Figure 6: Euro-Area Repatriation To End



Source: Deutsche Bank