Forex Focus: Euro's Rally Likely To Be Extended

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LONDON (Dow Jones)--The euro may well levitate against the dollar longer than expected.

Not only did European Central Bank President Jean-Claude Trichet manage to inject some more confidence in the single currency late last week but fears over a double-dip recession in the U.S. continue to linger.

Eventually, of course, concern about the upcoming euro-zone bank stress tests, the realization that Trichet really had nothing concretely positive to say and final proof that the U.S. economy is just going through a 'soft patch' will send the euro reeling again.

For now, though, euro bulls are getting their way, with the single currency trying to climb back over $1.2700 for the first time in nearly two months.

See the euro's performance:
http://www.dowjoneswebservices.com/chart/view/4244

Much of this was down to a remarkably cheerful performance by the recently very dour Trichet in his post-policy-meeting press conference on Thursday. He helped dispel fears that the euro zone itself is slipping back into recession and suggested that the recent rise in euro-zone money market rates wasn't an issue.

He sidestepped questions about the details of bank stress tests, the results of which should be out later this month, but still managed to calm financial markets and give the euro an obvious boost.

"It looked as if Trichet's main objective was to convey confidence," said Carsten Brzeski, senior euro zone economist at ING Financial Markets in Brussels.

If so, he certainly did the trick.

He was helped, of course, by a general improvement in global sentiment as equities rose and rate hikes in Malaysia and Korea added to optimism about the global economic recovery.

Confirmation that the U.S. wasn't going to name China as a currency manipulator after last month's release of the yuan's dollar-peg also helped sentiment.

For the euro's performance against the dollar, additional help came from the continued fear that the recent slowdown will tip the U.S. economy back into recession.

Confusion reigns, however, as data at the end of last week showing an unexpectedly large fall in jobless claims raised hopes that the slowdown is nothing more than a brief interlude.

Currency strategists at BNP Paribas reckon the dollar will rally back against the euro whichever way this confusion is resolved.

They noted that if a 'soft patch' is eventually confirmed, the dollar should rise as speculation over U.S. rate hikes increases again.

On the other hand, if a double-dip recession does look as if it is on its way, then a return to tight global credit conditions will be favorable for the dollar as well, with investors turning to the U.S. currency as a safe haven.

If this all coincides with poor, or unconvincing, stress test results and any new evidence that euro-zone banks are having difficulties raising funds, support that has been helping to keep the euro rallying for nearly a month and a half will soon disappear.

Early Monday, the euro was coming under selling pressure after initially benefiting from a rise in global sentiment at the end of last week.

News over the weekend that China's exports rose by 44% in the year to June helped to boost sentiment at first, but the data showed the increase may have been driven more by an increase in export prices rather than a rise in volume. Also, Chinese import growth was considerably softer, indicating that domestic demand in the country is slipping.

A resounding defeat for Japan's ruling DJP party in Upper House elections Sunday was also bad news as this will make it more difficult for the government to preserve fiscal discipline. Standard and Poors have already described the results at "potentially negative."

Like other financial markets, currencies will now be looking for the second-quarter earnings season that gets underway this week to supply more evidence on the U.S. recovery.

By 0645 GMT, the euro was down at $1.2592 from $1.2640 late Friday in New York, according to EBS. It was also down at Y111.85 from Y112.07.

The dollar was up, however, at Y88.83 from Y88.65.

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