Forex Focus: Euro Set To Run Out Of Steam

By Nicholas Hastings

A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--The euro's rise won't be sustained.

Sure, the single currency visited $1.30 for the first time in nearly three months.

In fact, given the current momentum $1.31 or more could well be possible, especially if next Friday's stress tests boost confidence in European banks as so many politicians insist they will.

The problem for the longer-term euro performance, however, is the same as it has been for the last few months--the euro-zone recovery and euro-zone interest rates aren't going to rise any faster than those in the U.S.

On the contrary, with euro-zone governments pursuing tighter fiscal policies while the U.S. authorities continue to spend, chances are that the U.S. recovery will eventually pull well clear of the euro zone's.

Any sign of this and recent euro gains will be quickly unwound.

For the moment, the single currency is still benefitting, not only from a sharp outflow of funds from U.S. markets but also from covering of previously extreme short euro positions.

Disappointing U.S. employment data, signs of floundering in the manufacturing industry and confirmation from the Fed's minutes last week that further monetary easing could still be needed all encouraged a wholesale selloff in the U.S. currency.

This coincided with successful auctions by several peripheral euro-zone debtors, including Greece, and endless reassurance that European banks will pass their stress tests with flying colors. Little wonder then that the euro became a popular destination as investors moved out of the U.S.

China also helped, with its leaders using a Beijing visit by German Chancellor Angela Merkel to talk up the euro, insisting that the currency remains an important investment vehicle for them.

But as the euro tests resistance at $1.30, the currency is no longer undervalued. It could be argued that at these levels it is overvalued and will soon start posing a risk to the euro-zone recovery by hurting exports.

This is certainly not what European politicians will want to see at a time when global growth is slowing, in line with China's carefully orchestrated deceleration of its own economy, and when fiscal tightening means that domestic demand is hardly likely to take up the slack.

This Friday's stress test results may well provide another reason for the euro to have at least a last hurrah.

The results will no doubt be polished to a shine to ensure that the health of European banks isn't put in doubt.

But, as details have shown, the tests aren't as strong as those for U.S. banks and they are unlikely to resolve the basic sovereign debt concerns that will continue to undermine the euro zone--there are still no serious sanctions that will stop another euro-zone debtor from defaulting.

In time, this will take its toll on both business and consumer confidence, ensuring that while investors worry about the pace of the U.S. recovery now, they will soon return to worrying about whether the euro zone can avoid another slide back into recession.

As Morgan Stanley reported last Friday, the time has come to start increasing short euro positions once again.

Around 0645 GMT, the euro was on the slide after rating agency Moody's downgraded Ireland's sovereign bond rating to Aa2 from Aa1 with a stable outlook.

Moody's cited weakened growth prospects as the main driver of the downgrade.

The euro currently trades at $1.2875, down from $1.2927 in late U.S. trade Friday.

Elsewhere, the major currencies are little changed with the pound trading at $1.5284, down a tad from $1.5298 and the dollar fetching Y86.66 from Y86.61 in late New York trade Friday.

Looking ahead, a light data calendar on both sides of the Atlantic will likely see the market looking to equities for guidance, with U.S. titan IBM delivering its second-quarter results Monday.

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 Reuters   USD/DJ
   Thomson   P/1066 or P/1074
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July 19, 2010 03:16 ET (07:16 GMT)