Forex Focus: Euro Bears Pick Time To Pounce

By Katie Martin

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LONDON (Dow Jones)--Have euro floggers given up?

It rather looks like they have.

The single currency has spent barely a moment under $1.25 against the dollar since the start of July, and data on speculative bets show that negative punts on the euro--not so long ago the laughing stock of the currency markets--are still very cautious.

To euro fans, this is proof that the market's assault on the currency at the start of this year was overblown, and that the European Union and International Monetary Fund's rescue package has put the euro area back on a solid footing.

To everyone else, this is still a blip. A big blip, for sure, but one that simply has to run out soon.

Right now, the bond markets are taking the strain. As Commerzbank's analysts pointed out Tuesday, euro-area government bonds, and the cost to investors of protecting against those bonds defaulting, still imply "a high probability of the Greek rescue package failing."

Meanwhile, aside from the cash currencies market, options "are pricing in a high risk of the euro nose diving against the dollar," the bank said.

So why is the euro itself not budging?

The complicating factor, analysts agree, is the U.S. economy. Expectations for interest rate rises from the Federal Reserve any time soon have pretty much evaporated. The once dominant view that the U.S. would raise rates quickly--a slam-dunk reason to sell the euro against the buck--has now switched into growing expectations for further Fed easing. That inevitably pushes the euro higher even though few believe that the euro area's woes have been solved.

Now, though, euro pessimists are growing increasingly confident that the currency bloc's structural problems will resurface as a big theme in the market, and the euro will tumble.

Simon Derrick, a senior currencies analyst at The Bank of New York Mellon in London, points out that judging by his bank's custodial flows, which capture portfolio shifts by investors around the world, it's clear that the tide is turning.

It's worth watching these flows. Back in early June, even while currencies analysts continued to predict a meltdown in the euro, they showed a slowdown in shifts out of euro holdings before the currency stabilized and later started climbing. In hindsight, Derrick said, they were a solid leading indicator of what was to come.

Now, "we're starting to get some outflows from the euro," he said. "The underlying structural issues have not gone away, and we could easily see stresses in Spanish or Irish banks bring them to the market's attention again," he said. Brace for the euro to buckle soon, he predicted.

Euro bashers have made these calls [unsuccessfuly] before, and they'll make them again. But whichever way you cut it, the possibility--no matter how small--that a euro-zone sovereign borrower could default, or that the euro could conceivably cease to exist in its current form, is a bigger negative than a spell of loose monetary policy in the U.S.

"The failure of the Greek aid package would be a disaster for the euro, as it would illustrate that effective aid measures within the euro zone are impossible," said Commerzbank's analysts Tuesday. "This scenario hangs over the euro like the sword of Damocles. As a result, the fact that nobody expects a U.S. rate rise does not support the euro against the dollar," the bank said.

Maybe this time the euro doubters are right. It would be foolish to ignore that possibility, particularly if Japan starts intervening to weaken the yen. If that were to happen, and push the dollar higher across the board, then euro bears could well seize their moment.

In early European trading hours Wednesday, the euro was a little higher against the dollar at $1.2716 from around $1.2675 late in New York Tuesday according to trading system EBS, reflecting a modest pickup in equities that signals stronger investor sentiment.

Similarly, the dollar was up against the yen at Y84.46 from around Y84, while the euro was at Y107.39 from Y106.50. Sterling was at $1.5403 against the dollar from $1.5350.

The Swiss franc was a little weaker, again reflecting a slightly more positive tone in the financial markets, with the euro trading at CHF1.2920. The single currency sank to a fresh all-time low of CHF1.2850 in New York hours Tuesday. The dollar was at CHF1.0161, a shade above its levels late in New York.

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