

Forex Focus: Euro Bulls Have Amnesia Attack

4 Oct 2010 , 09:47

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A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Are euro bulls having an attack of amnesia?

Or, are they just super optimists?

Last week the bulls sent the euro soaring to a new six-month high against the dollar, not because there was any particularly promising news about the euro-zone economy or euro-zone policy, but all because the U.S. is still debating the need for more quantitative easing.

As Washington watches the U.S. recovery flounder, the Federal Reserve is preparing to inject more liquidity to ensure that a double-dip recession is avoided.

Yes, this means that U.S. yields will come under pressure again and the dollar will become less attractive.

But, that doesn't mean that the U.S. currency should become less attractive against the euro.

Recent data from Germany may well have shown unemployment falling to an 18-year low and even the latest purchasing managers' index from the euro zone as a whole has proved even more buoyant than expected.

European banks contributed to the pretty euro picture too, lowering their demand for European Central Bank funding from the massive levels they were receiving before.

But, as most forecasters agree, the reality check for the euro zone has yet to come.

As last Friday's unexpected fall in German retail sales suggests, not only is domestic demand remaining sluggish but overseas demand for euro-zone goods will also stall as the global recovery slows.

In the meantime, last week's massive EUR50 billion bailout for Ireland's leading banks indicates just how high the financial risks remain.

Euro optimists may well point to the slide in euro-zone yield spreads as recent market tensions subside and investors become less concerned about the threat of sovereign debt.

However, it has to be remembered these yields were pushing up to new record highs at the start of last week and that the deficit reduction plans of most peripheral euro-zone debtors have many years to run.

The ECB, however, shows little sign of preparing to respond.

Unlike the Fed, the ECB is more eager to start mopping up liquidity, even though the implied tightening in monetary policy will prolong the economic slowdown and make life even more difficult for the cash-strapped debtors.

All eyes may have been on Ireland's bank rescue last week, but Spain may well have illustrated the problem even more clearly.

While Moody's lowered the country's credit rating, effectively increasing debt servicing costs, the latest purchasing managers' index for manufacturers fell under 50, suggesting that sector of the Spanish economy is back in recession.

So, who is buying the euro? And why?

New data from the International Monetary Fund show that foreign central banks have been busy in the last few months, hoping to boost their long-term holdings of the euro as they diversify out of the dollar.

Although major central banks have been pursuing this policy for some time, those of less developed nations appear to have joined the party, employing recent heavy inflows from dollar-based investors to buy the single currency.

Apart from that, euro supporters are either speculators hoping to just take a short-term bet on the single currency's latest rally or other investors choosing to ignore the reality of the euro zone's problems.

See how the euro has climbed:

<http://www.dowjoneswebservices.com/chart/view/4668>

There are, however, signs that this won't continue.

The performance of the euro against the dollar has long been closely correlated to the performance of equities. In recent weeks, though, the two have started to go their separate ways, suggesting that the euro's rally is hardly likely to last if equity markets don't hang on to their gains too.

But, perhaps technical analysis should have the last say. Now that it has broken up and over \$1.3700, analysts reckon that the euro could make it as far as \$1.4000.

After that, it is a different story, with neither the optimists nor the amnesiacs likely to have their way.

Early Monday, the euro appeared to be hit by profit-taking after an earlier rally in Asia. Sentiment had been lifted by comments from Chinese Premier Wen Jiabao that he supports a "stable" euro and that China will continue buying Greek bonds.

The yen, meanwhile, had come under pressure from speculation that the Bank of Japan will announce further monetary easing when it meets later this week.

By 0715 GMT, the euro was down at \$1.3738 from \$1.3784 late Friday in New York, according to EBS.

The single currency also fell to Y114.23 from Y114.81, while the dollar was a tad higher at Y83.37 from Y83.32.

Bloomberg TNI FRX POV

Reuters USD/DJ
Thomson P/1066 or P/1074

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October 04, 2010 03:47 ET (07:47 GMT)