Forex Focus: Euro Rally Built On Weak Foundations

By Nicholas Hastings

A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Confidence in the euro is rapidly draining away.

For the last week or so, the single currency has managed to stay above $1.30. On Monday, it even reached a three-month high at nearly $1.32.

But this support has had much more to do with dollar weakness than with independent euro strength.

If anything, the single currency has struggled to hang on to the gains it has made.

A break over $1.3050 has hardly given the currency the upward momentum that had been anticipated and even a stronger-than-expected manufacturing purchasing managers' index for the euro zone on Monday failed to provide anything more than a short-lived spike.

See the euro's performance over the last few days:

http://www.dowjoneswebservices.com/chart/view/4348

The problems for the euro are fairly simple.

Like most other major economies, the euro zone experienced a healthy economic bounce in the first half of this year, evidence of which is coming through in the data now.

In the euro zone's case, the bounce was probably even greater than expected given the weakness in the euro earlier in the year.

This has coincided with rising hopes that the worst of the sovereign-debt crisis in the region is over, especially after the results of recent bank stress tests were published the week before last.

In the U.S., meanwhile, economic data have disappointed. This has raised fears of a double-dip recession, increased talk of further quantitative easing by the Fed and driven U.S./euro zone yield spreads further in favor of the euro.

Spreads could well remain this way for now, especially if U.S. data continue to disappoint and if European Central Bank President Jean-Claude Trichet expresses any hawkish sentiments after this Thursday's policy meeting.

There are already fears that U.S. employment data Friday will show another 60,000 decline in non-farm payrolls. That would be less negative than the 125,000 fall in June but the improvement is already being put down to an increase in part-time jobs.

The problem for the euro, is that while the U.S. recovery may be slowing now, it is the euro zone that will be slowing next.

Mansoor Mohi-uddin, head of currency strategy at UBS, summed it up nicely: "The longer-term picture remains bearish. The structural problems of high debts, low growth and diverging current account imbalances remain, and fiscal austerity will likely undermine euro-zone growth this year and next. The ECB will not be in a position to raise interest rates until well into 2011, at the earliest."

Also, there is still the little problem of sovereign risk. While markets have calmed down for now, there remains a high risk of further funding problems, especially when the coming economic slowdown hits the already-suffering peripheral members of the euro zone.

So, as long as current fears about further monetary easing in the U.S. remain, the euro will probably continue to find support, helping to keep it around current levels.

But as yield spreads eventually start to move out again, chances are that the euro will swiftly see the end of its recent rally.

A story in the Wall Street Journal that the Fed is considering the purchase of new mortgage or Treasury bonds has raised the specter of further monetary easing in the U.S.

This has further undermined the dollar against the euro early Tuesday, with the single currency rising a little to $1.3276 by 0645 GMT from $1.3172 late Monday in new York, according to EBS.

The euro was unchanged at Y113.87 but the dollar also fell to Y86.39 from Y86.51.

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