Forex Focus: Renewed Euro-Selling Is On Its Way

By Nicholas Hastings

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LONDON (Dow Jones)--With the FOMC now out of the way, the euro zone's problems are coming back into focus.

And for the euro, that is not good news.

A renewed widening in yield spreads, heightened fears that peripheral European nations are falling behind their core peers and a general fall in appetite for risky assets all mean that the single currency will come under renewed selling pressure.

It isn't surprising that forecasts for euro parity with the dollar as early as next year are once more being expressed.

For the past few weeks, the euro has had some respite, reversing about one-third of its previous drop as investors were distracted by disappointing U.S. economic data and fears that the U.S. central bank's Federal Open Market Committee would extend its quantitative easing program.

In the event, the Fed's policy shift wasn't quite as radical as that but its downgrade of growth forecasts and its decision to preserve current liquidity levels once again undermined investor confidence in high-yielding assets.

The investor-pull back from the euro, which has already brought the single currency back down under $1.30 from over $1.32 in the immediate aftermath of the FOMC decision, is only likely to get worse in coming weeks as data show the euro zone's strong second-quarter economic performance already coming to an end.

See how the euro has already started to turn down against the dollar:

http://www.dowjoneswebservices.com/chart/view/4409

Earlier this week, industrial production figures from France showing a 1.7% fall in June gave a taste of things to come.

The problem is that this slowdown in the core countries of the region, such as France and Germany, will be even more damaging for the peripheral members that are already lagging well behind.

Now, with the Fed downgrading the U.S. outlook, and with both Chinese and Japanese economic data of late proving less robust than expected, the prospects for economic recovery in the euro zone and the wider world have deteriorated that much more.

As a result, worries about the euro zone's financial stability, and the ability of some peripheral countries to keep on funding their deficits, have once again started to rise.

Over the last few days the yield spreads of peripheral countries have widened relative to those of German government bonds and the cost of five-year credit default swaps from Greece, Ireland, Italy, Spain and Portugal have all risen.

And now, the rise seen in swap spreads between the euro zone and the U.S. in recent months is likely to reverse, ensuring that the euro loses much of its current yield attraction against the dollar.

The currency strategy team at Commerzbank AG puts it this way:

"It is unjustified that the spread between two-year dollar swaps and two-year euro swaps has widened from levels around 0 at the end of May to almost 70 [basis points] now. As soon as this realisation takes hold on the markets a part of the current euro strength is likely to disappear again."

Of course, a weak euro should help the core euro-zone countries by boosting their export income, but the peripherals will more than likely be left behind, increasing their divergence from the core, making a two-speed Europe more likely and putting the future of the single currency even more in doubt.

Early Thursday, the euro staged a small rebound despite a continued decline in Asian stock markets. By 0645 GMT, the single currency was up at $1.2887 from $1.2882 late on Wednesday in New York, according to EBS.

It was also up at Y110.21 from Y109.99.

The reversal was helped by a rebound in the dollar against the yen after its brief decline under Y85 on Wednesday prompted fresh verbal intervention from Japanese officials. Japanese Finance Minister Naoto Kan is said to have described the yen's recent moves as "rough" and a "little too rapid."

The U.S. currency rebounded to Y85.55 from Y85.37 as a result.

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