Forex Focus: Speculators Wrong Footed By The Dollar?

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LONDON (Dow Jones)--Dollar speculators have got it wrong.

The latest data from the Chicago Mercantile Exchange show that while they reduced their extreme dollar short positions slightly, after the Fed's QEII announcement Nov. 3, they are still holding shorts at extraordinarily high levels.

But, with U.S. bond yields now rising rather than falling, with the risk of contagion among euro-zone peripherals still increasing and with euro-zone growth about to falter, support for the dollar is only likely to grow.

First off--U.S. yields.

Contrary to initial fears, the Fed's second dose of QE may have proved slightly larger than expected but it hasn't been enough to halt market expectations of higher rates.

If anything, economic data coming out of the U.S. since the Fed's announcement has proved consistently better and forecasts for new figures out this week are equally optimistic.

With inflation expectations in the U.S. remaining stable, the rise in bond yields will make the dollar even more attractive in an uncertain world where investors continue to look for higher but safe returns.

Of course, developments in Europe are also proving dollar-positive.

See how the euro has already fallen against the dollar this month:

http://www.dowjoneswebservices.com/chart/view/4940

The performance of the debt-laden peripherals aside, market sentiment has been jolted over the last week or two showing that previously strong growth in the region's major economies, i.e. Germany and France, is slowing down rapidly.

In other words, all that talk that the European Central Bank will be able to remain hawkish while the Fed resorts to more easing looks a little premature. The ECB could now well find itself considering further measures to ease credit conditions.

The central bank has already been forced to provide European banks with much more short-term funding than expected in recent weeks.

Then, there is Ireland.

Dublin's resistance to a bailout is hardly a reason to buy the euro.

Fear that Ireland will eventually have to concede defeat on the budget front will continue to push yield spreads higher, especially given the renewed tensions in other peripheral debtors, including Greece and Portugal.

Eurostat figures earlier Monday showed that although Greece did manage to knock its budget deficit to GDP growth ratio sharply lower this year, the ratio started way up at 15.4% last year, two percentage points higher than previously estimated.

It isn't surprising that the Greek government is already alluding to the need for an extension on its bailout from the European Union. All this will hardly play well when the country launches its latest bill auction later this week.

Portugal isn't making things any better as it starts trying to get its budget-slashing plans through parliament ahead of a general election. The result is fairly intemperate comments by a government minister about the risks of being booted out of the euro.

All this will provide another reminder for investors about the risks of buying the single currency.

So even if Ireland does cave in to pressure and seeks a bailout, any improvement in yield spreads and support support for the euro is likely to prove short-lived, ensuring that the dollar remains supported and that speculators need to continue cutting their short positions.

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