FOREX FOCUS: Which Market Is Right? Stocks Or Currencies?

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LONDON (Dow Jones)--So which is right then? The equity market, which is telling us that all is well? Or the currency market, which is telling us it most certainly isn't?

Take equities first. London's FTSE 100 blue-chip benchmark is now within a whisker of the 6000 level. It's at its highest point since early June 2008, well before the collapse of Lehman Brothers, and has risen by more than 70% since the low reached in March last year.

Here's a typical quote from an equity expert, John Praveen, chief investment strategist at Prudential International Investments Advisers: "We remain positive on the outlook for stocks in 2011, with a favorable macro backdrop, solid earnings and attractive valuations."

Then there's currencies, where the euro/Swiss franc exchange rate continues to sag to new all-time lows. For now, that rate is as good a proxy for risk as any, tracking the really-very-risky euro against the not-very-risky-at-all Swiss franc.

Anyway, the euro was buying more than 1.68 Swiss francs back in October 2007. Now it buys just 1.25; a fall of more than 25%.

Here's what the currency strategists at Credit Agricole CIB say in their just-published FX Outlook 2011: "It is difficult to rule out bouts of increased risk aversion over coming months, especially given the unresolved problems in the euro zone but also potentially due to heightened tensions in the Korean peninsula and (monetary) policy tightening in China, among other factors."

So, is the equity market right to focus on what appears to be a solid if modest global economic recovery, or is the currency market right to focus on all the hurdles that lie ahead?

For what it's worth, higher commodity prices and rising bond yields would appear to support stocks' optimism. Moreover, many experts think the Swiss franc has 'overshot', outperforming even gold, and will soon correct lower.

Technically, the strong negative correlation between equities and the euro/Swiss franc exchange rate may well break down.

However, it is also worth considering that the larger and more liquid currency market is sounding a warning that the other asset markets would do well to heed amid the optimism that's widespread at the end of this year. And that means that while risky currencies like the euro may well recover some lost ground in 2011, a bad year for them overall against havens like the franc is a possibility it would be wise not to ignore.

As for equities, any slowdown in the global economy--as some expect in the second half of 2011--could well sound the death knell for the rally.

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