

FOREX FOCUS: The Limited Life Of 'Euphoria'

24 Jan 2011, 13:33

By Nicholas Hastings  
A DOW JONES NEWSWIRE COLUMN

LONDON (Dow Jones)--This latest wave of "euphoria" should start hitting the rocks soon.

At the moment, the wave is skimming over the euro's problems.

A widening in yield differentials over the U.S. in the last two weeks, optimism over a more permanent solution to the euro-zone debt crisis and even increased interest from sovereign buyers have helped to drive the single currency back up to a two-month high against the dollar.

Data showing a sharp reduction in short futures positions earlier this month suggests that hedge funds and other speculators are also looking more favorably on the euro for now.

But, as these figures from the Chicago Mercantile Exchange also show, speculators are still only hedging their bets--showing little sign of actually increasing their long positions in the single currency just yet.

This isn't surprising.

Yield differentials may have moved in the euro's favor but they probably won't go much further.

Given the European Central Bank's focus on headline inflation, the recent rise in oil prices is likely to have more of an impact on its policy than on the policy of the Fed, which focuses more on core inflation.

ECB President Jean-Claude Trichet has also constantly raised the hawkish ante, warning of growing price pressures. However, economists reckon there isn't even a remote chance of the ECB raising rates at this stage, despite the ECB's hawkishness, because of the poor state of the non-core euro-zone economies.

Euro gains built on optimism over resolution to the debt problems of the peripheral euro zone are also likely to have a limited life.

Bullish talk about plans for the European Financial Stability Facility and even suggestions that early Irish elections might be good for the euro have contributed to the single currency's rally.

But this seems to ignore the facts that expansion of the EFSF has yet to be agreed by euro-zone heads of state and that the debt levels of the peripheral countries will continue to grow, keeping the threat of a sovereign default alive and well.

Meanwhile, the collapse of Ireland's coalition government may not come as any surprise and an early general election may remove some of the immediate market uncertainty. But there still remains the risk that any new administration in Dublin will seek renegotiation of the austerity measures on which Ireland's EFSF bailout is built and which helped to bring the last government down.

The single currency could also find that its recent rally has less to do with rising interest in the euro and more to do with waning interest in currencies elsewhere.

China and Japan, as well as other Asian and Middle Eastern sovereigns, have been cited as euro buyers. Bank of New York Mellon points to renewed outflows from the dollar in the last two weeks, with China showing new impatience about Washington's benign attitude towards the dollar's decline and with the uncertainty created by Japan's renewed interest in yen intervention.

But only time will tell how long these flows will last. In the meantime, as Stephen Gallo, head of market analysis at Schneider Foreign Exchange, warns: "Be on the look out for too much 'eurphoria'".

Bloomberg TNI FRX POV  
Reuters USD/DJ  
Thomson P/1066 or P/1074

January 24, 2011 07:33 ET (12:33 GMT)