MARKETS

All eyes on euro's slow-motion train wreck

BY PHIL BURGERT

Pressures on the European currency are filtering into outlooks for major and emerging market currencies. Meanwhile, the U.S. dollar is maintaining its safe haven status despite being undervalued vs. most G10 currencies.

The struggling euro currency, the sovereign debt issues of Europe and the growing European economic recession with the implications those developments present to economies throughout the rest of the world continue to confront currency traders more than three years after they first emerged.

Despite a flurry of activity ahead of a European Central Bank (ECB) meeting in early August and promises to do everything possible to save the euro made by ECB President Mario Draghi, foreign exchange traders and analysts were left with the conclusion that little had changed in the slowly unfolding Eurozone drama.

Euro weakness
Purchasing power parity
Carry spreads

"The central bank ultimately has run into a pushing-on-string type scenario whereby they can do all the QE (quantitative easing) and all the monetary easing they want, but at the end of the day these problems have to be addressed in some way, shape or form. That's probably going to involve pain," says Dave Floyd, head of market strategy for the Aspen Group. "That's what everybody wants to avoid, and that's understandable, but it's probably going to take a while for this thing to unfold and it's probably going to be like a slow train wreck rather than some sort of sharp, drastic event. Most of the potential scenarios that could happen are known at this point. It's that wild card that nobody sees coming."

Floyd notes that the S&P 500 and the euro usually are correlated tightly, but that correlation now is weakening (see "Decline of the euro," right). "The S&Ps may rally five handles, but we're lucky to get a fraction of that move higher in the euro. That is a key sign from a relative strength standpoint that the euro still is under a lot of pressure. We would not be buyers — in fact, we'll be looking to sell the rally," he says.

Floyd says the reason for a tentative downside is that the market doesn't know what is going to unfold in Italy or Spain. "We have a pretty good indication of what they are facing vis-à-vis what we saw in Greece but simply on a larger scale. As those yields continue to rise in Spain

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and Italy, they cannot finance at those levels. It's simply not possible. So, what we have is a foregone conclusion that there are going to be issues."

Dean Popplewell, senior currency analyst for Oanda Corp., says the euro is in a downward leg. "The intraday charts seem to be convincing most technical analysts that there certainly is scope for further weakness." He notes that many are looking to re-establish single unit shorts on upticks.

"This has been an ongoing play for quite some time. One of the most difficult parts out of all of this is how short the market actually is. It's very much a one-directional play, and we currently are seeing record shorts," Popplewell says.

He adds, "We're not seeing proactive measures by the policy makers in Europe. They seem to be relying more on rhetoric. It is this rhetoric that is providing these short inter-day blips in the currency itself."

Popplewell notes that Spanish yields

are close to euro-era highs suggest unsustainable financing levels that put Spain in danger of requiring a formal bailout. Fears of provinces declaring bankruptcy also are behind the suggested floating of a financial bailout from the European Union and International Monetary Fund (IMF), he says.

Fundamental Eurozone data is pointing to a rapid regional slowdown, Popplewell says, noting that Eurozone companies had cut output for the sixth consecutive month in July. "One of the other things that people, and especially capital markets, are focusing on quite heavily is the flight of cash," he says. "Everybody is very fearful of Spain. The market has come to the realization that Greece can be and should be cut loose, but the market is very fearful of a sovereign handout to Spain because of its prominence on the global ladder."

A weaker euro will help the periphery of Europe by easing monetary conditions and helping to stimulate exports, says Marc Chandler, global head of currency strategy for Brown Brothers Harriman & Co. He notes that U.S. fund investments are leaving Europe.

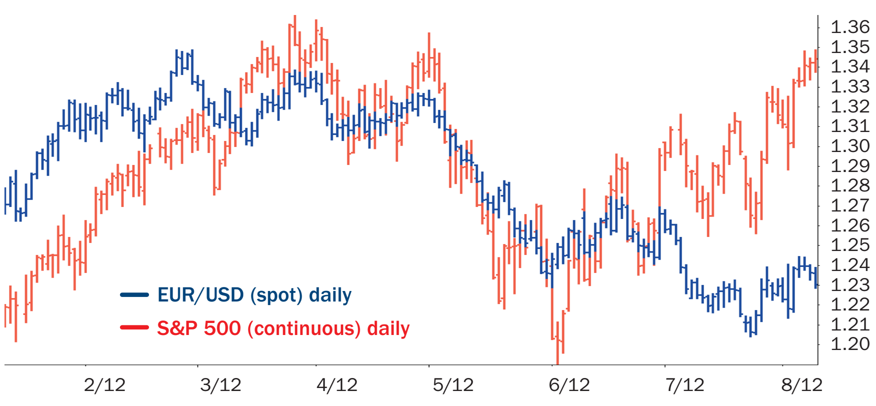
"It is also part of the solution," he adds. "The euro has been overvalued for the better part of a decade. It probably needs to be undervalued for some time." Chandler notes that the Organization for Economic Co-operation and Development (OECD) and IMF measures of purchasing power parities recently put the euro at about 3% undervalued. This is negligible because the currency of a major industrialized country typically is plus or minus 20% on the scale (see Trailing the field," page 18).

Of the G10 currencies, the euro currently is the only one that is undervalued against the dollar, Chandler notes. "Most of the currencies still are overvalued against the dollar," he says. The most overvalued now is the Australian dollar at 38% while Norway is almost as high at 37%.

"What's happened recently in a big kick to the head of mean reversion trades is that the euro was overvalued and now is slightly undervalued," Chandler says. "There also have been very clear trends of Australian dollar higher and euro lower in momentum trading and there have been some carry trades because there are some countries that have negative interest rates."

DECLINE OF THE EURO

The euro's usually tight correlation with equities is seen by traders as weakening with the currency.



Source: eSignal

For example, he notes that Germany's recent two-year yield has been -5 basis points while Switzerland's has been -56, Denmark's -33 and Finland's -2. "So basically what that means is you get paid. We used to think that zero was the lower bound of interest rates, but what's happened in the recent period is we've seen negative interest rates of the creditor nations in Europe," Chandler says. "For the first time, Germen and French two-year interest rates are below Japan's."

In a carry trade you want to sell a low-yielding currency and buy a higher yielding currency, Chandler says. "So for countries like Germany, what that suggests is that the euro can be a carry trade. One could sell the euro and buy a higher yielding currency like the Australian dollar, New Zealand dollar or Canadian dollar (see "Carry opportunities," right). And that's in many ways what has happened."

Ultimately, the situation for the euro is a crisis primarily of confidence, says Ilya Spivak, currency strategist for DailyFX, the research unit of FXCM Inc. "It's not so much that people are afraid that a country like Greece, Italy or Spain will default, the danger is that nobody has any idea what that default would look like."

Spivak says that if anybody had a clear base line for pricing what the worst case scenario likely would be, the markets would reflect that and move on. "But here you don't have any kind of clear precedent for what the end-game is. So, as you continue to face uncertainty, you're going to

CARRY OPPORTUNITIES

While much of the West has been stuck in a long-term, near-zero interest rate environment, there are carry trade opportunities by going long emerging and commodity currencies.

Country	Current rate
Brazil	8.00%
India	8.00%
China	6.00%
South Africa	5.00%
Australia	3.50%
New Zealand	2.50%
Norway	1.50%
Canada	1.00%
European Monetary Union	0.75%
United Kingdom	0.50%
United States	0.25%
Japan	0.10%
Switzerland	0.00%

Source: FXStreet.com

continue to face downward pressure on the euro as people basically say 'I just have no idea what is going on here,'" he says.

Spivak notes that there is no legislative framework for a country to get out of the Eurozone, and there is no concept of what it means for a country inside a currency union to default when certain other members — notably Germany — are very sound. "It's very difficult to say what the worst case scenario is because the markets have a hard time actually pricing assets based on this," he says.

The main beneficiary of the euro's problems continues to be the U.S. dollar. "It's not so much a vote of confidence in the U.S. economy as a flight out of the various risks, notably Europe. But that still tells you to what extent people would rather let the U.S. Treasury hold onto their money than almost anything else," Spivak says.

Chandler adds, "The dollar is in a bull trend or a rising cycle, which probably still has a bit more time to run. It just so happens that there are uglier sisters at the ball. If I were to bet on what country can reinvent itself, I would bet on the U.S. over Europe and Japan."

The weakening prospects of the euro to serve as an alternative reserve currency also are being accompanied by a weakening outlook in China — partly resulting from recession in Europe — that also is pushing back speculation of the renminbi moving toward internationalization.

The best/worst of the rest

Chandler says the strength of the Japanese yen has been befuddling policy makers, investors and observers. It often is claimed to be a safe haven, even though the country does not have a triple-A rating, has a debt-to-GDP ratio of more than 200% and continues to be plagued by deflation.

But Chandler suggests the safe haven and carry trade claims for explaining pre-crisis periods of weakness for the yen have not been examined closely. He says there are no signs that foreign investors have stepped up purchases of Japanese financial assets to back up the safe haven theory.

"Judging from currency futures, speculators also cannot be cited behind yen strength," he says, noting that the gross long position as of the week ending July 17 was a modest 36,700 contracts. In early February, speculative gross positions were more than 85,000, a multi-year high, but they then fell to a multi-year low near 1,000 by the end of March.

"Japan is no longer the low interest rate country," Chandler says. He adds that Japanese investors are continuing a strong preference for foreign fixed income investments over equities, with the recent four-week moving average of foreign portfolio investment near a two-year high.

Popplewell says that the yen and Swiss franc no longer are being relied upon for safe haven positioning. "The Swiss is tied to the euro at its 1.20 [peg], so the market cannot play that as a safe haven go to," he says (see "No vacancy," above). "With regard to yen, the market is very worried about the Ministry of Finance and the Bank of Japan," which have been vocal and increasingly adamant about intervention in their currency.

Such intervention would have a negative portfolio impact, Popplewell says. He adds that "strapping on yen is somewhat of a dangerous scenario short-term" and that buying dollars remains more of a prudent play.

Analysts and traders say the so-called "commodity currencies" are now less tied to commodities than to overall world growth trends. "There's a correlation between Canadian dollar, crude oil and the S&P or the Australian dollar and crude, although Australia is not a major exporter of crude," Spivak says.

"Commodities have been keeping us on the defensive," Floyd says, who notes that a weaker euro, weaker Aussie and weaker S&P all go together.

"If you can gauge with a high degree of certainty where the S&Ps are going vis-à-vis commodity prices — they tend to lead — it helps set us up in the currency market because all of these asset classes are closely tied. It's what we call our version of intermarket analysis," he says.

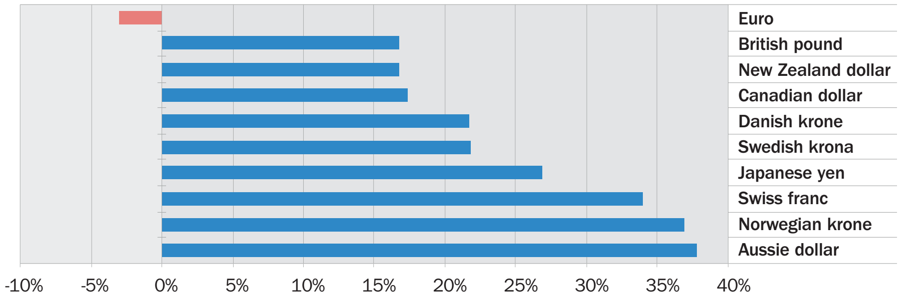
Floyd adds that the Turkish lira and Singapore dollar also are among safe haven currencies at times when the euro's correlations against other major asset classes break down. "They're not as impacted sometimes by the winds of the S&Ps and other major asset classes that drive currencies," he says.

There are few true safe havens and fewer countries who want to take the import hit of a stronger currency. F

TRAILING THE FIELD

The dollar is undervalued significantly against all the G10 currencies expect the euro based on the OECD's purchasing power parity measure.

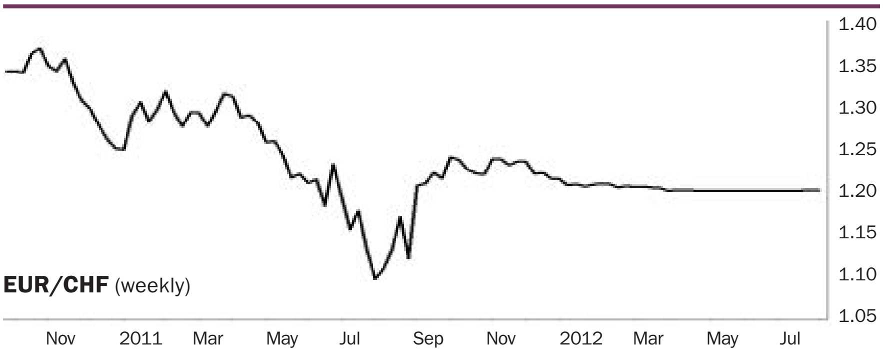
Overvauled/Undervalued vs. USD



Source: OECD/Bloomberg

NO VACANCY

The Swiss Central Bank pegged the franc to the euro at 1.20 last September, preventing the euro from dropping below 1.20 Swiss.



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