

18 April 2008

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## EURO RALLY CRACKING?

Like an errant child initially doing the opposite of parental wishes only to quickly capitulate, the euro is ending the week on a soft note after having reached record highs against both the US dollar and British pound.

Downside corrections in the euro this year have been brief, lasting 4-6 days, but sharp, covering roughly 5-6 cents. If this pattern, which of course really reflects the behavior of market participants, is to be repeated, the euro is likely to fall back toward \$1.53-\$1.54 by late next week.

Also in this vein, we note that the euro has not closed below its 20-day moving average since Feb 18. That average comes in near \$1.5753 as the week draws to a close.

To be sure, such short-term patterns are not the kind of thing one wants to bet the proverbial farm on, but it is a ballpark guess of what to expect in the near-term. But more than that, it provides a bit of a metric to evaluate the pullback in the euro. At the same time, a euro pullback on these sorts of terms in both magnitude and duration would likely be regarded as "normal" by the euro bulls and momentum traders.

Momentum traders clearly have had the whip hand this year. The rise in risk aversion undercut carry strategies, which had been the go-to play in the currency markets for so long, and the yen and Swiss franc outperformed during the credit crisis. The end of the carry game surrendered much of the foreign exchange terrain to the momentum traders.

Value investors, who expect their investment to return its underlying worth, essentially employ mean reverting strategies, with the mean here meaning value. They want to buy low and sell high.

Momentum traders are a different kettle of fish. They buy high, not wanting to pick a bottom—that is for value investors—and expect to sell even higher. Momentum traders are trend followers, buying when it is going up and selling when it is going down.

They have been whipsawed badly in recent days. The knee-jerk reaction to the G7 statement was to sell the euro, but in less than 24 hours it had recouped the initial sharp loss. And as momentum traders scrambled to re-establish their long euro positions, they lifted the single currency to new record highs against the dollar and sterling. Then at the week's end the euro sold off hard again. Momentum traders appeared to throw in the towel after the higher than expected euro-zone March CPI (3.6% year-over-year) failed to push the euro through the psychologically important \$1.60 threshold.

It stands to reason that how market participants interpret the news stream impacts prices, but the opposite is also sometimes true. Sometimes the news stream is interpreted through the lens of the price action.

This is to say that the psychological significance of the rejection of the \$1.60 level and the subsequent reversal of the euro's fortunes will likely encourage market participants to see the news stream as euro negative.

While many market fundamentalists are disturbed by the aggressiveness of US officials to avoid what they perceive to be a cleansing deflation of debt, many investors are concluding that it doesn't pay to take on city hall. US officials are so determined and the instruments at their disposal still seem adequate, that the fundamentalist will not win this battle. The fundamentalists will though continue to warn that without the baptismal waters of a full blown financial crisis, until many more debtors and creditors are punished for their greed, the next crisis will be all the worse. Paying the piper can be delayed, but it will still be a witch.

To be sure, the S&P Case-Shiller index shows no let up in the pace of declines in US house prices, which in some ways is at the vortex of the financial crisis. They have fallen every month by more than the previous month for nine consecutive months. The US economy is still stagnant and possibly even contracted slightly here in H1, but the market is being forced to give the Federal Reserve the benefit of the doubt in its forecasts for a better H2.

In contrast, the ECB seems rigid and all too willing to risk a sharper downturn in the economy in an attempt to demonstrate its anti-inflation credibility. The IMF has sharply cut its GDP forecast for the euro-zone this year to 1.4% this year and 1.2% next year. It claims the ECB has room to cut interest rates. The ECB obviously disagrees. Although there was some strong rhetoric after the March CPI report, it is difficult to take seriously any implied threat to raise interest rates.

Europe still typically relies on exports to service foreign markets, while the US and Japan's auto industry service foreign markets more by building and selling locally (US sales by majority owned affiliates will sell something on the magnitude of four times goods that the US will export this year). There may be much talk about how a strong euro is a sign of the correctness of official policies, the truth of the matter is that many in Europe prefer a stronger dollar in general, not just now.

Strains within Europe appear most acute when the US dollar is weak. Such strains are evident now. The premium Europe, both within the euro-zone and without, has to pay above Germany has widened markedly. Countries on the periphery, like Portugal, Spain, Greece and Italy in the past would attempt to regain competitiveness lost by devaluing. France, if the pressure became unbearable might seek a re-valuation of the German mark (rather than a devaluation of its franc). This path has been cut off.

Our best guess is that in six months from now the US will be looking better, while the risk is the euro-zone will be looking worse. This is a market for value investors and in the currency markets, it means the dollar, which according to various models of valuation, has rarely if ever, been cheaper, nor Europe dearer.

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