

Second Half Outlook for Euro

The Euro has done well through the first half of 2011, rallying to fresh multi-year highs against the US Dollar and strengthening against almost all G10 counterparts. There remain clear fundamental risks for the single currency in the second half of 2011, and we look for the Euro to fall. The major concern is whether several at-risk countries can remain stable despite clear debt crises. The European Central Bank's next actions may prove pivotal—especially as the Euro has strengthened on robust interest rate forecasts and is at risk of losses on any significant downgrades. The number of risks to the Euro arguably outweighs those to the US Dollar, leaving us watching for further EURUSD declines. We look for the EUR/USD to end 2011 below 1.25.

European Sovereign Debt Crisis – Where Did We Start and Where Do We Stand?

The euro zone financial debt crisis continues to threaten EUR stability and remains a key risk through the second half of the year. At the forefront of traders' minds is Greece—can the southern European state withstand market pressures and remain solvent?

Despite a €110 billion three year bailout agreement with the European Union and International Monetary Fund, Greece has yet to see the light at the end of the tunnel. The difficulty lies in the structure of the bailout deal. When the International Monetary Fund agreed to loans, it required that the Greek government return to the debt markets for its borrowing needs as soon as 2012. At the time, this request seemed reasonable. With backstops from the EU and IMF, international investors would be more likely to buy Greek debt. Yet the continuing sell-off in Greek bonds underline that few are willing to hold existing Greek debt—much less buy any newly-issued debt.

The cost to insure against a Greek debt default has recently hit record-highs as seen through Credit Default Swaps, and current sovereign debt ratings imply a 50 percent chance of a Greek default within the coming five years.

A further bailout seems increasingly necessary and likely, but uncertainty over Greece's ability to repay debts could likewise spread to other at-risk government treasuries.

Spain and Portugal Outlook Uncertain on Funding Needs

The key risk with periphery debt crises has and will always be contagion—will Greece's troubles affect other periphery nations and even spill into the core through higher bond yields? In absolute terms, bailouts for Greece, Portugal, and Ireland have cost relatively little. Together, the three economies comprise approximately 5 percent of total euro zone Gross Domestic Product. If EMU titans Spain (8.9 percent of GDP) and Italy (12.8 percent of GDP) fall into trouble, however, European coffers may not be able to cope with the required fiscal aid.

The spread between benchmark Spanish and German government bond yields has recently widened to its largest since the inception of the euro—implying that Spain's relative debt risk is worsening. And though a 10-year Spanish government bond yield of approximately 5.5 percent is low by historical standards, the widening gulf could further exacerbate government deficits. Much the same can be said for Italy. A key question is whether bond troubles in periphery nations can spread to the core, truly threatening the stability of the single currency zone.

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Of course, there have been plenty of reasons that the euro has strengthened despite these readily apparent sovereign debt crises.

European Central Bank – Can They Continue to Hike Rates?

Expectations that the European Central Bank will be among the most aggressive central banks in raising interest rates has driven speculative interest in the euro, pushing the price up in the first half of this year. A key question will be whether the ECB will follow through on lofty forecasts and continue to raise interest rates, further supporting the currency.

Robust interest rate forecasts have driven the euro higher against the US Dollar and Japanese Yen—currencies that hold the dubious honor of the two lowest-yielding among the industrialized world.

Overnight Index Swaps, a tool used by major financial institutions to bet on and hedge against interest rate moves, show that traders expect the ECB could raise rates three times through the second half of 2012 in order to head off inflation in the Euro Zone. This compares to forecasts that the US Federal Reserve will leave interest rates roughly unchanged through the same stretch. The Bank of Japan is similarly forecast to leave monetary policy effectively unchanged and to keep Japanese short-term interest rates near zero.

Yet in markets nothing is guaranteed, and indeed we might argue that the euro has seen about all of the yield-linked support it will enjoy. That is to say, it would likely take a material improvement in ECB forecasts (and subsequent rate hikes) to continue driving EUR gains.

Can the European Central Bank continue to set hawkish monetary policy despite clear economic and fiscal struggles in periphery nations? ECB President Jean Claude Trichet has continued to emphasize that the central bank sets policy for the whole of the monetary union and cannot ignore mounting inflationary pressures. Yet with fiscal austerity packages guaranteed across the euro zone, demand-driven inflation could quickly abate and lessen the need for tightened policy.

All else remaining equal, the euro would almost certainly fall on a sharp downgrade in ECB interest rate expectations. Of course, nothing ever remains equal in financial markets and there are a number of mitigating factors that could strongly affect the single currency.

Financial Markets Continue to Drive Currencies

The euro remains a currency closely linked to equities markets, with the EUR/USD tending to rise with stocks, and tending to fall when stocks fall. Further market turmoil could almost certainly derail the recent EUR strength. The correlation between the Euro/US Dollar currency pair and the US Dow Jones Industrial Average has recently been trading near record levels; Dow variation has theoretically explained up to 45 percent of Euro movements. Part of this relationship is the US Dollar's appeal as the currency of many popular "safe" investments—most notably US Treasury Bonds. On the other side of it, the euro is arguably among the most at-risk assets in financial market upheaval as debt market difficulties could further exacerbate the current European sovereign debt crises.

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The Dow Jones Industrial Average limped into the second half of the year, declining for six consecutive trading weeks and posting its worst performance in nearly a decade. It should come as relatively little surprise that especially sharp equities sell-offs forced EURUSD weakness, and indeed a continuation could see the US Dollar further regain ground against its high-flying European counterpart.

Euro in Favorable Long-Term Trend but with Considerable Risks in the Second Half of 2011

The Euro remains well within a decade-long uptrend against the US Dollar, but the medium-term outlook is fraught with risk as doubts remain about euro zone economic and political stability. Of course, the US Dollar is not without its own issues and actual EURUSD price action will depend on a great number of different dynamics.

Whether or not the euro remains in its broader uptrend will greatly depend on developments in sovereign debt crises and market expectations regarding the European Central Bank. It seems that risks generally favor Euro losses, and indeed our forecast remains bearish into the end of 2011.

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