

Forex Focus: Dollar Should Get Its Safe Haven Status Back

By Nicholas Hastings

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LONDON (Dow Jones)--The higher the euro rises against the dollar, the further it is likely to fall.

For the past month or more, the single currency has been climbing as fears of a double-dip recession in the U.S. have grown and the outlook for U.S. rate hikes has been scaled back.

The loss of the dollar's safe-haven status has allowed the euro to benefit as fears over the euro-zone debt crisis subsided.

See the euro's recent rally against the dollar:

<http://www.dowjoneswebservices.com/chart/view/4226>

The market's shift in favor of the euro was emphasized by the rise in two-year German/U.S. yield spreads all the way to +5 basis points from -30 points a month ago.

It isn't surprising that the euro has rallied nearly 5% as those double-dip fears rippled through financial markets.

However, indications are that the market's fears about the stalling U.S. recovery may be overdone.

Yes, growth in the U.S. in the second half of this year is unlikely to be as strong as in the first, and the U.S. Federal Reserve is unlikely to start moving rates higher again just now.

But that doesn't mean that the U.S. economy will fall back into recession or that the Fed will have to ease monetary policy some more, as many have feared.

Daragh Maher, deputy head of global foreign exchange strategy at Credit Agricole in London, explained it thus: "The double-dip brigade still need to battle against the reality that non-residential investment in equipment and software is rising strongly, as firms upgrade and modernise their capital stock. Strong profits growth provide the ammunition for this expenditure, with rising capacity utilisation providing the impulse for action."

Put this together with strong export growth and the fact that the government's fiscal stimulus still has more to run later this year, and the currently bearish view of the recovery looks distinctly overblown.

"There are clearly headwinds to activity, but these point to a curtailed upswing, not an outright reversal," Maher concluded.

Of course, there are still risks abroad for the U.S. economy. Chinese growth is slowing and worries over the global recovery remain high.

Not all is gloom, though, as the Reserve Bank of Australia surprised markets with its more upbeat economic assessment Tuesday suggesting that there is room for the central bank to hike rates again as early as September.

Just as the pessimism surrounding the U.S. outlook has been overdone, so probably has the recent optimism over the euro zone.

Certainly, recent data from the stronger core members have come in better than expected and even the peripheral debtors have been able to continue raising funds in the open market, dispelling fears of an impending sovereign default.

But the crisis in the region is far from over as politicians and the European Central Bank struggle to resolve the issue of a unified policy.

"Questions over the long-term sustainability of the monetary union in the face of diverging economies remain unresolved," said Michael Hart, a currency strategist with Citigroup.

Of more immediate concern for the euro will be the stress tests on major euro-zone banks to see if they could withstand any serious loan crisis without causing contagion to financial markets as a whole.

The results of these test are due to be released July 23 after they have been studied by the ECB and major banks.

On the one hand, they could help boost confidence in the euro zone and the euro, even providing room for the single currency to extend its gains for now.

But, as Hans Redeker, head of global foreign exchange strategy at BNP Paribas in London, warned, "questions remain about whether the tests are strenuous enough: any suggestions that the final results are too rosy would be counterproductive."

So, euro buyers should beware as the single currency's rally against the dollar appears increasingly unjustified.

Early Wednesday in Europe, the euro was slipping as global sentiment turned negative after Tuesday's disappointing U.S. Institute for Supply Management data for non-manufacturing industry.

By 0645 GMT, the euro was down at \$1.2590 from \$1.2619 late on Tuesday in New York, according to EBS. It was also down at Y109.95 from Y110.42.

The dollar fell to Y87.33 from Y87.48 as the yen once again showed its safe haven status in times of nervousness about the global economy. In Japan, the Nikkei fell 0.6% in line with a general decline in Asian stocks.

Bloomberg TNI FRX POV

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Thomson P/1066 or P/1074

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