«The dollar is landing, they say…»

In February, European banks were extremely bearish on the greenback. In hindsight, they hit the mark. A new survey this week shows an optimism tempered by moderation. On average, 1.30 is considered a good equilibrium level for the euro versus the dollar.

By Vincenzo Sciarretta

A couple of months ago we were struck by a February survey of this magazine that pointed to a very strong consensus: 8 out of the 10 largest banks in continental Europe were betting on a rising euro and a declining dollar (one bank did not provide any comment). The consensus was confirmed after listening to 5 additional international players (see the table below).

On average, the analysts articulated their reasoning as follows: "we believe the structural problems of the dollar are going to outweigh the interest rate differential in favour of the US." Today, looking back, they proved to be entirely right

This week, *TheEuropeanSide* updates the survey and finds that the prevailing view among experts is that the euro should fluctuate around the current level.

Professionals have adopted the thesis that a number of factors are working to hold down the American currency, including the higher level of global interest rates, a large very current account deficit, potentially slowing growth in the United States, and the implicit message about dollar weakness advanced in the G7 communiqué. But everything has a price, and 1.30-1.33 is considered the

YEAR-END TARGET PREDICTED ON FEBRUARY 20, 2006

YEAR-END TARGET PREDICTED ON MAY 5, 2006

The Dollar Is Doomed, They say…

8 out of the 10 largest banks in continental Europe were bullish the euro in February.
The bias is more balanced today

Banks	Analyst	on February 20, 2006		on May 5, 2006	
		target:	Trend	target:	Trend
Largest banks on the continent					
UBS	Team	1,3	Up	1,3	Sideways
Banco Santander	not willing to release any comments				
Unicredito	Roberto Mialich	1,28	Up	1,28-1,30	Sideways
BNP Paribas	Team	1,32	Up	1,32	Up
Credit Suisse	Marcus Hettinger	1,11 - 1,13	Down	1,20	Down
Société Générale	Niels Christensen	1,26	Up	1,27-1,30	Sideways
ABN AMRO	Tony Norfield	1,28	Up	1,28	Sideways
Crédit Agricole	Olivier Bizimana	1,27	Up	1,30	Sideways
Fortis	Francoise Bernard	1,25 - 1,30	Up	1,25 - 1,30	Sideways
Banco Bilbao	Team	1,20 - 1,25	Sideways	1,27	Sideways
Deutsche Bank	Team	1,27 - 1,30	Up	1,30	Sideways
Selected international players					
Merrill Lynch	Alex Patelis	1,29	Up	1,29	Sideways
Morgan Stanley	Stephen Jen	1,24	Up	1,24	Sideways
Bank of America	Robert Sinche	1,30	Up	1,32	Up
Nothern Tust	Victoria Marklew	1,35	Up	1,35	Up
Independent Strategy	Bob McKee	1,30 - 1,35	Up	1,30 - 1,35	Up

Fonte:The European side

Yes, I would diversify…

Ed Bohene, ex Fed

*We asked **Edward Boehne**, former President of the Federal Reserve in Philadelphia, "If you were a central banker today in a country that held a substantial percentage of its reserves in dollars, would you contemplate some diversification?"*

His response was, "Yes, I would. With the euro, and even the yen, some change would be reasonable." He stressed, however, that "if you are a major central bank, you must be careful that diversification does not lead to destabilization.

The Chinese, for instance, may want to remix their portfolio, but they must be judicious because the US is a large market for them. So if you are a minor central bank, diversification is probably more relevant to you than for major central banks that have to consider underlying macro factors."

As a follow up to that question, we asked whether he would also take gold into consideration for reserve purposes. "If I were an Asian central banker" he replied, "and calculated the number of dollars that I have, well, I would look for some diversification… and given the options for currencies, yes, I can see some purchases. But I do not expect gold to exert any critical role in monetary authorities' decisions.

What I envision here is some diversification of portfolios into gold." (For a different perspective, see "Confessions of a Former Central Banker" in this issue).

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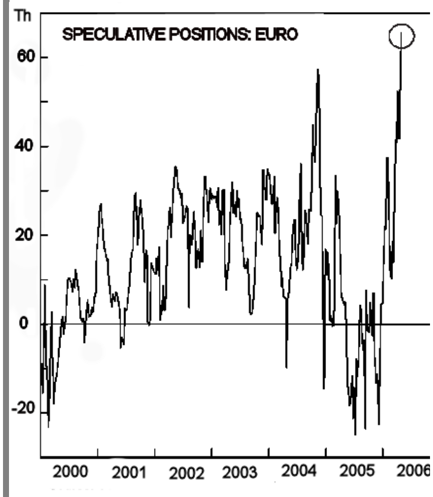
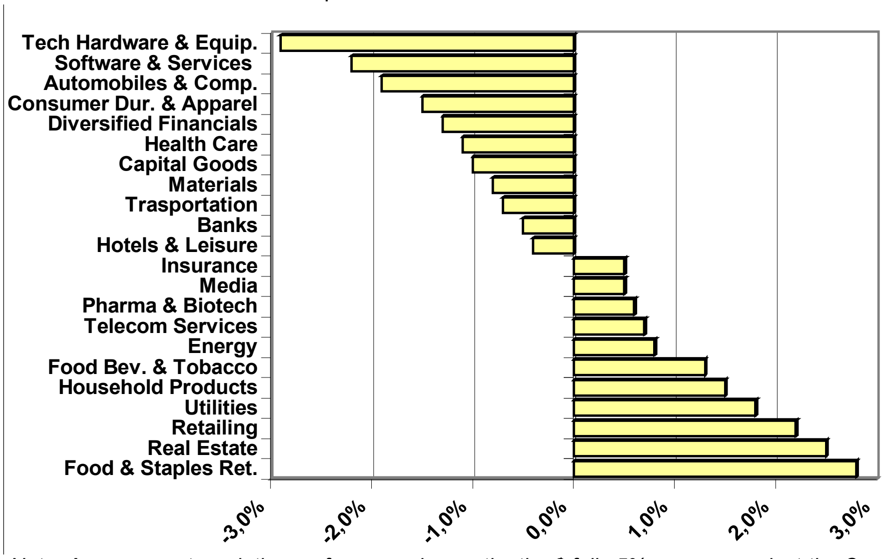
Speculators are long the euro



*The current rise in the euro has been accompanied by a speculative frenzy in the futures market. Long positions are so established, in fact, that they are setting records, a sign, in the past at least, that a setback or a reversal lies ahead. According to **Steve Quigley** of BCA Research, however, the risk is limited. "Currency futures are only a very small fraction of the foreign exchange market," he says, "and they are home to mostly short-term and momentum-based traders."Therefore, any setback will be easily offset by long-term investors buying the currency, as well as foreign central bank purchases."*

Average Sector Performance When $ Falls 5% in One-Month



Note: Average sector relative performance in months the $ falls 5% or more against the €.

Stock investors always try to look at the exchange rate since continental bourses have historically reacted to dollar swings. They usually tend to strengthen under the impetus of a strong dollar and to weaken when the greenback endures a downward spiral. Whether you are bullish or bearish the euro, you may want to take a look at this chart with the sectors' susceptibility to the ups and downs of the dollar/euro.

An old chart from Morgan Stanley

symbolic threshold for 2006. "The last time that the currency ratio of euro to dollar appreciated at a similar rate", says **Niels Christensen** of Société Générale, "was back in the second half of 2004, when it rose above 1.30, soaring to an all-time peak of 1.3665. Today, however, we see several factors that should prevent a replay of that scenario. First, the euro trades with a negative carry, that is, interest rates are higher in the United States than the euro zone. Second, the European Central Bank (ECB) is likely to insist on a policy of benign neglect as long as the common currency does not develop too much momentum. Above 1.30, we think, the ECB is likely to lower expectations of a rate hike. Third, there is the political reality: the euro zone is now running a monthly trade deficit with China of 7-8 bln, almost double the deficit of two years ago. Add to that the fact that the euro has appreciated by roughly 3-5% versus the yuan since the innovation of the Chinese exchange rate system last July. All this leads us to believe that central bankers will discourage a strengthening of the euro that is turning into a wild swing."

If structural problems of the dollar prepared the ground for its decline, various announcements and declarations set off the selling wave. The importance of the G7 communiqué as a catalyst is already well recognized, so let us not tire our readers with a rehearsal of its content. Instead, let's listen to the expert consensus what the document means. "Yes," says **Roberto Mialich** of Unicredit, "the currency market is tracing the pattern established after the Group of Seven met in Dubai in 2003." **Olivier Bizimania** of Crédit Agricole echoes this sentiment, noting that "in the abstract, the G7 statement put emphasis on further appreciation of Asian currencies to

The Euro Sceptics

With a year-end target of 1.24 for the dollar against the euro, ***Stephen Jen*** *of Morgan Stanley is among those sceptical of an endlessly strengthening euro. He contends that the optimism about the common currency is not matched by its outlook and derives from different expectations that investors bring to European and American markets. "I continue to be frustrated by the fact that investors treat Euroland as innocent until proven guilty," he writes, "while treating the US as guilty until proven innocent, particularly if we consider that the potential growth rates in the two areas will be significantly different, even if Euroland does recover toward its low potential rate."*

The analysis, he says, supports the claim. "Our calculations show that a 20% rise in the euro against the dollar, a rise that would be a reasonable projection if the current talk of wholesale diversification by Middle East funds and Asia reserves turned out to be correct, could essentially push the European Central Bank to adopt a zero interest rate policy," in order to counterbalance the effects of moves in Asia and the Middle East. Jen also disagrees with the idea that we are seeing a replay of the misalignment of 1985-86. "The US currency is sound and not overvalued. It may weaken due to cyclical forces but is unlikely to plunge for structural reasons."

Another Euro sceptic is ***Marcus Hettinger****, a foreign exchange strategist for Credit Suisse who thinks that a strong US economy combined with a positive interest rate differential would tend to strengthen the dollar. Accordingly, he has a dollar target of 1.20 against the euro by December 2006. If his diagnosis is correct, the greater dynamism of the American economic engine should continue to attract foreign capital and support the move into dollar assets.*

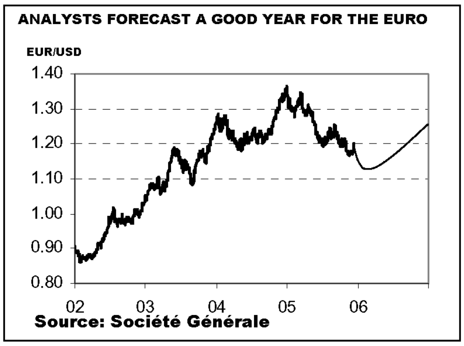
The dollar is vulnerable to a decline in interest rate differentials

Percent of current account financed by interest rate sensitive inflows

	Q4 1987	Q1 1989	Q1 1995	Q2 2000	Q4 2005
Bonds	*5*	*45*	*81*	*47*	*80*
Short-term	*34*	*10*	*2*	*-43*	*4*
Total	**39**	**55**	**83**	**3**	**84**

Source: *Merrill Lynch. Bonds are fixed income assets greater than 1 year in maturity. Short-term includes money market paper, bank deposit are other items. Q4 2005 is the most recent available data. The other dates mark the end of tightening cycles in the US.*

In a recent study, Merrill Lynch Chief Global FX Strategist, **Alex Patelis** calls attention to the great share of the US current account deficit that is financed by interest rate sensitive inflows. His analysis compares the share of such inflows at the end of past Fed tightening cycles with the current situation. The share today is a significant 84 per cent. The fact leads him to conclude that "in this environment, the willingness of foreigners to finance the US current account deficit should be particularly sensitive to changes in Fed policy, especially at the time when central banks outside the US are in a period of rate normalization."



help reduce global imbalances. But market players read it for what it said indirectly, that is a weak dollar." Mialich also points out the fact that a powerful group of industrialists in the US claimed that the dollar was at least 10% overvalued, starting their lobbying in anticipation of the November 2006 congressional elections.

In addition, analysts mentioned the article by Martin Feldstein, chief economic adviser to Ronald Reagan, in which he suggested that the US should allow the dollar to go down as in the second half of the 1980s. Finally, a recent speech by Alan Greenspan arguing for stronger Asian currencies were interpreted to mean that the outlook for the greenback was bearish. In short, many got the signal that the dollar could be sold almost without risk. Skyrocketing levels of speculative long positions in the futures arena confirm that more than a few investors acted on this signal.

The other hot topic that has emerged in recent weeks centers on reserve diversification by international monetary authorities following the announcement of the Swedish Riksbank that they had shifted their reserves out of the dollar and into the euro. As for the professionals surveyed by this *TheEuropeanSide*, several of them manifested some scepticism, claiming that traders are acting on expectations but that, based on official data, diversification from USD to EUR is not large. "Little real change, so far", comments **Bob McKee** of Independent Strategy. "There are no real data," adds **Tony Norfield** of ABN AMRO. "Central banks would be crazy to bring on a stampede out of the dollar at this stage." The same attitude is taken by **Nancy Verret** of Fortis Bank who thinks "diversification has a minor role in this moment"

Analysts were much more impressed with the shift in the dynamics of growth and monetary policy on both sides of the Atlantic. "The two factors that kept the dollar stable last year," contends **Victoria Marklew** of The Northern Trust Company, "were the high growth differential over Europe and the high interest rate differential. Now both are softening, making it less compelling to invest in the US. This has to be considered in the context of a huge US current account deficit and a substantial fiscal deficit. Thus, market expectations will support the euro and undermine the dollar."

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