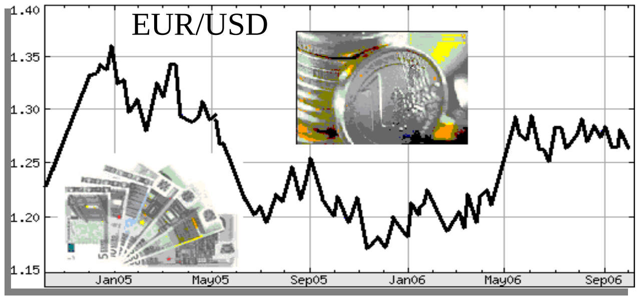
# Five Questions on the Euro

Consensus opinion is bullish on the euro. Let's test the thesis.

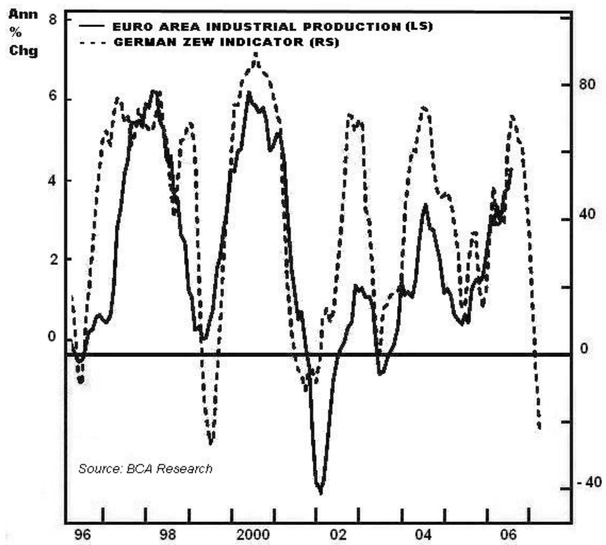
By Ferreo Babbila

*TheEuropeanside* has asked two experts to linger on five points which in our opinion could cause some weakness in the euro. Their response? Our fears notwithstanding, the euro is likely to appreciate. The two experts are Merrill Lynch's Jason Daw, and Niels Christensen, Société Générale's currency strategist.

For what we hear around, their point of view is representative of prevailing market expectations.




German leading indicators point south




***Argument number 1**: Leading indicators such as the ZEW index have plummeted suggesting a weakening of the dynamism in Continental Europe. Further, starting from 2007, both Germany and Italy (50% of EMU GDP ed. note) will engage in a fiscal tightening campaign. Shouldn't these events reduce the attractiveness of investments in Euroland?*

**Niels Christensen**: "Yes, slower growth in the Old Continent ought to reduce global investors' appetite for our stocks, which have been outperforming their American and Japanese counterparts. That said, the environment will not necessarily be negative for the euro. The central bank in Frankfurt is expected to keep on moving interest rates up in 2006, while the Federal Reserve is likely to begin cutting the cost of borrowing during the second half of 2007. Hence, the interest rate differential ought to move in favour of the euro."

**Jason Daw**: "On the whole, German indicators continue to point to above-trend growth into 2007."

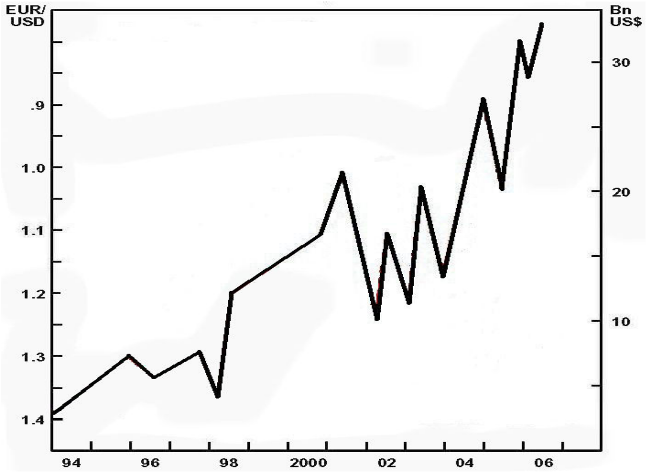
***Argument number 2**: Gold sometimes leads the euro against the dollar and gold has recently suffered from a nasty break. May such a movement carry with it the seeds of the next correction for the common currency?*

**Christensen**: "I do not see a strong correlation between gold prices and the euro versus the dollar."

**Daw**: "It is true that in general the greenback is negatively correlated to precious metals. In any case, the performance often diverges from the long-term pattern. In fact we can envision the possibility of a rising euro over the next few months."

Gold has suffered from a nasty break: May the euro follow?

**European investors keep on buyng US bonds**




***Argument number 3**: Europeans have been buying a lot of US bonds. The interest rate differential may taper off a little bit, but is still likely to remain in favour of US cash and bonds. Shouldn't this preserve the prevailing bias toward US financial assets?*

**Christensen**: "The numbers reveal that the purchases of US Treasuries are largely from London. And the fact means real buyers can be from everywhere. We suspect a lot of them are located in the Middle East; in other words we are speaking of petrodollars recycled into fixed income assets. In this regard, the spread is not the leading factor".

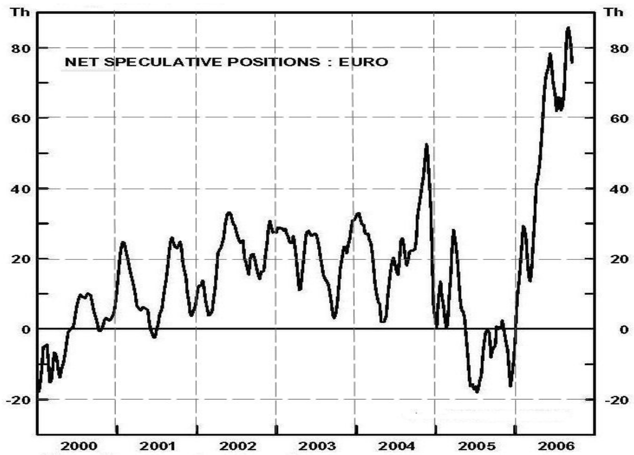
**Daw**: "Our work suggests that when global interest rates are rising – which is the case today with most monetary authorities in tightening mode – the currencies of countries with high yields and current account deficits tend to under-perform. This would suggest a weaker dollar."

***Argument number 4**: Speculation is still short the dollar, long the euro: if some operators lose their conviction and cut back their exposure, might the euro correct of its own accord?*

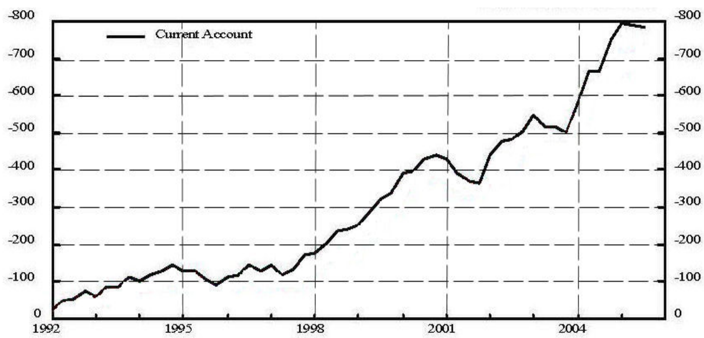
**Christensen**: "Sure, as long as the exchange rate moves sideways, a reduction in the speculative positions may cause a fall in the euro. It would be short-lived. I expect investors to enter the market and buy the single currency on the weakness because the fundamentals would not change."

**Daw**: "Market positions have been pared back recently. The futures data shows that net euro long exposure has been declining since the 15th of August. It is our contention that positioning is not stretched."

**Euro: speculation is already long**




**US ever-increasing deficit:**
**If there's a slow down, shoudn't the deficit decline?**




***Argument number 5**: If the US economy slows down, shouldn't the current account deficit go down? And since the US deficit is mirrored by trade surpluses around the world, if the US slows down decisively, shouldn't other countries suffer as much as North America?*

**Christensen**: "Yes, in the abstract one would expect the US trade deficit to narrow. In the most concrete terms possible, I think the slowdown will be moderate, or very moderate, with no major relieve to the twin deficits."

**Daw**: "Merrill Lynch economists see a consumer-led slowdown in America with GDP growth dropping sharply from 3.4% to 1.9%. The good news is that there are strong sources of growth outside the United States, including consumer demand in China and India, European demand in general, and business investment in particular, and demand from commodity exporters. The demand emanating from all these sources ought to slow non-US global growth only from 5.7 in 2006 to 5.2 in 2007."