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21

Euro starts to crack as investors eye exit

By Alice Ross

As the prospect of Greece's exit from the euro has become more widely debated, so the single currency has begun to tumble.

Yet its losses so far have been muted, in contrast to the volatility in some European equity and bond markets. While the euro has dropped 4 per cent this month against the dollar, it still remains above its January lows.

The euro's resilience has been vexing currency traders for the past year. Since the debt crisis erupted in the summer of 2010, the single currency has actually risen 7 per cent. On Wednesday, even as the euro dipped below $1.27 against the dollar for the first time since January, Citigroup, one of the largest foreign exchange dealers in London, said its clients were net buyers of the single currency.

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But analysts now believe the single currency could be reaching a tipping point. Investor behaviour suggests that the props that have supported the currency in recent months are weakening.

There are three main theories to explain the euro's continued strength in the face of the worsening debt crisis.

First, government bond investors have tended to switch their holdings from the so-called "periphery" of Europe to "core" countries such as Germany and France. This has created no downward pressure on the single currency.

Second, central banks have continued to diversify out of dollars and into the euro this year.

Third, speculators remain very short the euro, ramping up bearish positions on the single currency last week to the highest level since mid-February. Such positions tend to be closed on days when the euro drops, causing it to rebound.

The first of these is losing its potency.

French balance of payments figures released this week show that foreigners bought a net €27.7bn of French assets in March, up from €18.8bn the previous month. That supports the theory that investors were moving assets earlier this year from peripheral countries such as

Spain and Italy to core countries, though the figures do not break down whether that money is coming from within the eurozone or outside it.

However, a more recent analysis of Japanese investors, the biggest overseas buyers of euro-denominated assets, by Nomura suggests that this trend may have petered out.

Japanese investors piled back into European bonds earlier this year as global risk appetite improved, buying $13.8bn in January and $11.5bn in February, a period when the euro rose 3 per cent. But, in March, investment slowed to just $2.2bn. And Nomura calculates that, in April, Japanese investors sold overseas assets at a record pace, with a net $32.7bn brought back into the country.

"This idea that foreign investors are buying the core was the story of February and March but not the story of today," says Jens Nordvig, foreign exchange strategist at Nomura.

Central banks also appear to be slowing their euro purchases. Official figures on central banks' foreign exchange reserves from the International Monetary Fund are incomplete – they do not include figures for China – and delayed. The most recent data to the end of December did not show a significant pullback in global euro-denominated foreign reserves. That helps to explain the euro's resilience for much of last year.

In depth

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Emerging market central banks, moreover, piled up reserves at the start of the year amid the global growth spurt. With many emerging markets exporting commodities, that creates dollar-heavy stockpiles that central banks seek to diversify into other currencies, such as the euro.

But that growth has since slowed. Indeed, Nomura calculates that while emerging market central bank holdings rose in January by $83.9bn, they rose by $57bn in February and by just $16.4bn by March.

In addition, some central banks have been less keen on the euro this year. The Swiss National Bank said this month it had cut its euro reserves from €120.5bn in the fourth quarter of last year to €103bn in the first quarter of this year, preferring to diversify into sterling instead.

Alan Ruskin, foreign exchange strategist at Deutsche Bank, says: "If longer-term investors, like central banks, start to lose confidence in all existing countries remaining in the eurozone, then we will have turned a page and the story is potentially hugely negative for the euro."

"I am concerned that central banks will start to look at the euro differently in the midst of the Greek turmoil," says Mr Ruskin. "I don't think one can be complacent that central bankers will maintain their existing euro allocations in the uncertainty."

If these signs that investors and central banks are losing appetite for the euro continue, it would raise questions over another popular theory: that investors are happy buying European assets despite the prospect of a Greek exit from the single currency as they believe the euro would be stronger without its weakest member.

The demand from investors for euro-denominated assets has meant that the euro's losses have been relatively restrained. But analysts believe that a slow descent for the single currency has begun, with some forecasting $1.15 or $1.10 by the end of the year. The euro may finally be cracking.

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