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Sentiment turns bearish towards euro

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The post-summit shine on the euro has faded quickly. Despite initial gains for the single currency, when European leaders acted on Friday to tackle the eurozone's debt crisis with help for troubled banks, sentiment is overwhelmingly bearish.

The single currency fell below the $1.26 level against the dollar at one point yesterday, having risen nearly 2 per cent late last week to almost $1.27 following an EU leaders' summit that agreed to allow the European Stability Mechanism, the eurozone's new bailout fund, to inject funds directly into Europe's banks.

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It now faces another challenge. Tomorrow analysts expect the European Central Bank to cut interest rates for the first time since December, from 1 per cent to 0.75 per cent.

The usual response to a rate cut is for a currency to weaken, and many investors believe a weaker euro is precisely what Europe needs. The ECB last month cut its growth forecasts for next year from a range of zero to 2.2 per cent to zero to 2 per cent. It expects eurozone growth this year to be between -0.5 and 0.3 per cent.

FX Concepts, the currency hedge fund, believes it is in the ECB's best interests to talk the euro down amid the recessionary environment.

"We would argue that even if the eurozone were to solve its banking and sovereign funding problems, the depth of its developing recession should drive the value of the currency down about 20-30 per cent from current levels," wrote John Taylor, chief investment officer at FX Concepts, in a recent note to investors. "A corollary of that argument is that the European Central Bank should be assisting this fall."

But if the ECB is hoping to weaken the euro with a rate cut, it could be disappointed, at least in the short term.

Foreign currency analysts say any action by the ECB is likely to be viewed as positive, purely because it is being seen to take steps to address the eurozone's sluggish growth. That means a rate cut is more likely to send the euro higher than lower.

Furthermore, a 25 basis point cut is largely priced in, making it unlikely the euro will respond. Many believe the ECB would need to cut rates by at least 50 basis points to boost sentiment.

"If we get a 25 basis point cut as expected, there won't be a huge impact on the euro," says Geoffrey Kendrick, foreign currency strategist at Nomura. "A 50 basis point cut may actually be positive for the euro, while no change would send it lower at this stage."

The ECB has other tools it could deploy. These include increasing the ECB's bond-buying programme, seen as unlikely, or lengthening the repayment time for loans made under its longer-term refinancing operation earlier this year.

An extension of the LTRO would probably be seen as negative for the euro over the medium term. Previous rounds in December and February led investors to borrow euros to invest in emerging market currencies, for example.

However, foreign currency analysts are turning more bearish on the euro regardless of any action taken by the ECB. At the end of May, after a difficult month for the euro amid fears that Greece could leave the single currency, analysts from Bloomberg were predicting the euro would be $1.28 by the end of the year. Since then, those predictions have been cut to an average of $1.23.

Some analysts still believe the threat of Greece leaving the euro is being ignored by the markets, with the country yet to agree a renegotiation of its bailout package. Many are looking to next week's meeting of eurozone finance ministers as the likely forum for renegotiation between Greece and its eurozone partners. A disappointing outcome would weigh on the value of the euro.

Capital Economics, a London-based consultancy, predicts the euro will trade at about $1.10 by the end of the year, having "pencilled in" the departure of Greece, Portugal and possibly Ireland. "We see the euro depreciating quite a lot further as concerns about a possible break-up of the eurozone continue," says Jennifer McKeown, senior European economist.

Euro bulls are hard to find. Even those with forecasts significantly higher for the end of the year – including BNP Paribas and HSBC with $1.35 – believe the value of the euro will be driven by dollar weakness rather than positive developments in the eurozone. Many believe the biggest factor in the euro's favour remains the prospect of further monetary easing by the US Federal Reserve.

Positioning on the euro remains extremely bearish. While short positions on the single currency have fallen from recent record highs, speculators increased their euro shorts again in the week to last Tuesday, according to data from the US Commodity Futures Trading Commission.

The options market also shows investors are bearish on the euro, with greater demand for protection on the downside than the upside for the value of the euro against the dollar. Any boost from the ECB could therefore be temporary.