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Euro the big loser after central banks intervene

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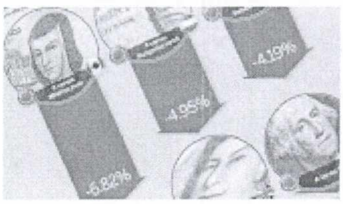
The clear loser in the currency markets after three of the world's big central banks either cut interest rates or embarked on more emergency bond-buying was the euro.

The single currency tumbled against every other big currency after the European Central Bank cut its main refinancing rate by 25 basis points, as expected, and unexpectedly reduced the deposit rate it offered banks to zero.



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It fell to below $1.24 versus the dollar, hitting its lowest level in a month and more than giving up the gains it had made since last week's summit of EU leaders.

Analysts say the effect of the ECB's decision is to eliminate the interest rate advantage the euro has had over other big currencies, including the dollar and the yen.

This is encouraging investors to use the euro as a funding currency for "carry" trades, borrowing in a low-yielding currency to invest in a higher-yielding one. "It's right at the forefront in terms of funding currencies," says Alan Ruskin, foreign currency strategist at Deutsche Bank in New York.

The ECB's move, furthermore, has opened opportunities in a number of so-called euro crosses – selling the euro against emerging market currencies and currencies of smaller industrialised nations.

Indeed, traders say Thursday's price action suggests that the "risk on, risk off" trade – where only the dollar and yen rise when risk appetite is high and fall when investors are risk-averse – is showing signs of losing its grip on the currency markets.

The Australian dollar was well supported after the People's Bank of China cut interest rates unexpectedly, giving riskier, commodity-linked currencies that have close economic ties with China a boost.

At the same time, emerging market currencies such as the Mexican peso and South African rand were relatively strong.

"This is an independent sell-off of the euro outside the risk-on, risk-off parameters," says David Bloom, foreign currency strategist at HSBC.

Borrowing euros to invest in emerging markets was a popular trade at the start of the year, after the ECB's longer-term refinancing operations, aimed at boosting bank lending, were widely interpreted as a form of monetary easing.

Such trades died away as fears over the global fallout from Europe's debt crisis stoked fears of a euro break-up, causing all big currencies, except the dollar and the yen, to fall in May. They have now become popular again.

The euro hit a four-month low against the Mexican peso Thursday, dropping more than 1 per cent.

It also hit its weakest level since March against the South African rand, another emerging market currency closely correlated with global risk appetite.

Benoit Anne, emerging markets strategist at Société Générale, says: "The correlation between the euro and emerging market currencies is being destroyed."

Trades in emerging market currencies are also becoming more popular with currency investors due to a frustration with the lack of movement between the world's big currencies and the constant spectre of central bank intervention.

The dollar, yen, sterling and euro all have close to zero interest rates while central banks in the US, Japan, UK and the eurozone have already eased or are expected to ease monetary policy further, keeping
the currencies under pressure.

Some European currencies are showing fresh signs of resilience, though, with investors seeing the Norwegian krone and Swedish krona, as well as sterling, as havens from the eurozone crisis.

Harmonic Capital, the London-based hedge fund, is among investors taking short positions in the euro against the Norwegian and Swedish currencies based on expectations for higher economic growth in the Scandinavian countries. Richard Conyers, chief investment officer, says he is also seeing greater opportunities for trading emerging market currencies against each other than in the big currency pairs.

The pound has long benefited from negative sentiment on the eurozone, typically rising against the euro in recent months when the euro falls against the dollar.

Thursday's expected Bank of England move to add a further £50bn to its asset purchase scheme did not reverse that pattern.

The pound rose 0.7 per cent against the euro to its strongest level since mid-May even as it fell against the dollar and the yen.

Analysts say they expect the relative attractiveness of UK assets and the pound to continue as foreign investors carry on buying gilts because of their status as one of the few remaining triple-A rated assets. All eyes are now on Friday's US non-farm payroll figures as a key barometer of expectations for a third round of monetary easing in the US.

Stronger than expected US jobs data added to the positive sentiment on the dollar Thursday, after private sector payrolls rose more strongly than expected in June, according to ADP data, with 176,000 jobs added compared with an expected 100,000.

While a move by the Fed is widely expected to cause the dollar to weaken against all other currencies, including the euro, investors are betting the euro will stay weak versus other big currencies.

That, they say, would be the case regardless of whether the US embarks on a third round of quantitative easing.

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