Euro Rallies on US Uncertainty

Despite the news that the ECB had cut interest rates by 0.50% to 2.75% the euro has rallied over 2% against the dollar over the last two weeks, taking it a three year high of $1.0239. This brings its gains in the year to date to 14.1%. Breaking through key chart levels around $1.0210, the currency also rallied to five month highs against sterling and a nine month high against the Swiss franc. The euro's rise is associated with concerns about geopolitical risk, in particular a potential US war versus Iraq, unease over the outlook for the US economy following the Fed's recent decision to reduce official interest rates to 1.25% and doubts about the US commitment to a strong dollar policy.

Markets reacted negatively to the shock resignations of US Treasury Secretary Paul O'Neill and White House economic adviser Lawrence Lindsey. Traders are still trying to get a handle on the incumbent US Treasury Secretary, John Snow, and there are concerns that the administration will move away from a strong dollar policy. Coming from an industry background, there is a risk that he might be biased towards a weaker dollar, and look to undermine the currency in a subtle way. However, given the current uncertainty surrounding the US, we do not expect Mr. Snow to make any formal policy change and do not see him as an overwhelming threat to the dollar.

There are however, other factors which could impact negatively on the dollar, not least of which is thin holiday trade which could have as much of an impact on forex levels as economic fundamentals. At this point a move by the euro to $1.03 and beyond is very possible. With interest rates in Europe at 2.75% and official rates in the US at 1.25%, rate differentials will continue to lend underlying support to the single currency until the Fed signals that it is believes that the US economy has recovered to a point where it feels comfortable in moving to a tightening bias. We do not expect this to occur until well into 2003. The risk of further volatility in US stocks and the possibility of move to war versus Iraq in the New Year also pose risks to the US currency. A record high current account deficit will also weigh on the dollar. Data released yesterday showed that the deficit narrowed in Q3, but it remains at an unsustainable level nonetheless. The dollar's fundamental back-drop is not supportive right now.

Short-term therefore, the currency will remain under pressure. However, while the dollar is still overvalued we do not believe that a sharp appreciation in the euro is sustainable over the longer-term. Despite the focus on the performance of the US economy, growth is weaker in Europe. Data released last week showed that the economy expanded by just 0.3% in Q3, for a meagre year-on-year increase of only 0.8%. Domestic demand remains very weak, up by just 0.3% on year earlier levels, with stronger exports responsible for most of the growth in the economy. Yesterday's sell off in the dollar helped take the focus of the fact that French industrial production declined 0.6% in October. This followed a dismal production report from Germany, which showed a 2.0% contraction over the month.

Leading indictors do not suggest any short-term turn around in economic numbers in the eurozone. Activity surveys show that the manufacturing sector contracted for the third consecutive month in November, while the services sector expanded at a very modest pace. The EU Commission's economic sentiment indicator for the eurozone continued to fall in November. It declined to 98.6 from 98.8 in October and 99.0 in September, led by a marked decline in consumer confidence. This may partly reflect deteriorating labour market conditions. The latest data show that the unemployment rate edged up to 8.4% in October in the eurozone. After a recovery in the first half of the year, the growth outlook has deteriorated significantly. At this point, the risks for another down-leg in eurozone growth are significant. The ECB announced yesterday that it was cutting its growth forecast for 2003 by a full percentage point to 1.1-2.1%.

Meanwhile, data from the US have been mixed to good. Consumer confidence levels have rebounded, retail sales are holding up reasonably well in the face of a rising unemployment rate and the housing market has cooled but remains strong. Conditions in the manufacturing sector remain difficult but there are some bright spots on the horizon. Meanwhile, activity in the services sector rebounded sharply in November, increasing by 4.3% over the previous month. Overall, we expect 2003 to prove to be another year of below trend growth for the US economy. However, after a slow start, GDP growth could still average around 2.5% for the year, with activity picking up pace in H2 2003. This is well above the growth rate forecast for the eurozone.

Earlier this year, the euro pulled back from a high of $1.02. At that time its failure to sustain upward momentum against the dollar reflected the inherent weakness of the eurozone economy and inactivity on the part of the ECB. For the short-term, the policy mix should favour the euro, which has established strong support at $0.9850. A clear break of $1.03 would confirm a corrective rally, which would likely continue into 2003 if there is a war against Iraq. Over the longer-term, however, we see little scope for a significant appreciation in the currency. The scale of policy adjustment in the US should provide a boost to the economy over the course of 2003. Eventual outperformance in terms of economic fundamentals should lend support to the US currency allowing scope for a recovery in the second half of next year, by which time we anticipate a return to a $0.95-1.00 trading range.

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