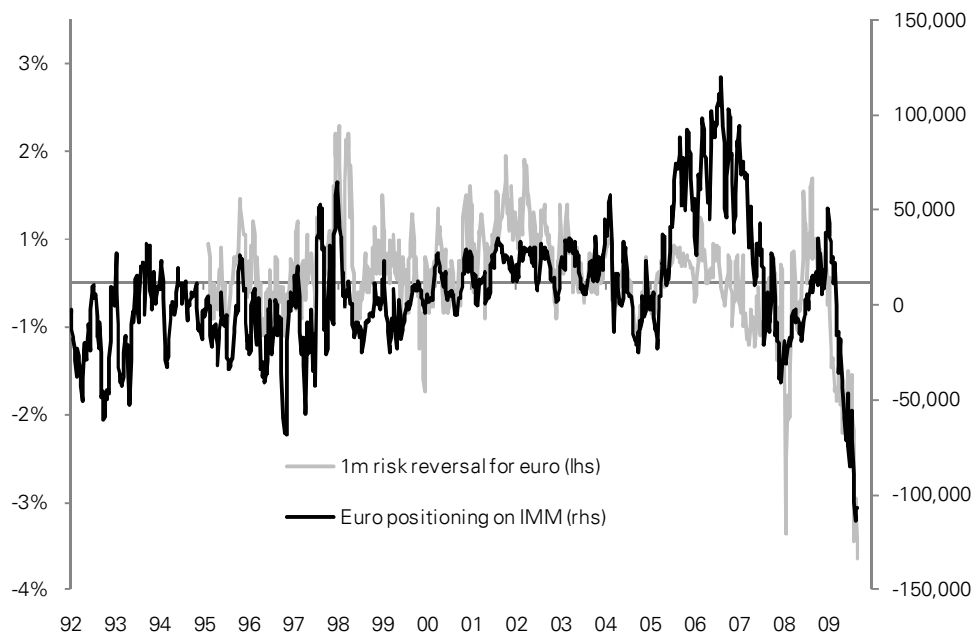


In Defense of the Euro

Sentiment has turned extremely bearish towards the euro, thanks to escalating concerns over the Euro-area system. The next month or two could see a move to fair value of 1.15 as there are little signs of sentiment turning. However, past July, Spanish sovereign and bank redemptions ease significantly, and the ECB may more actively reduce risk premia by increasing government bond purchases. The combination of low interest rates and a growing current account deficit will also weigh on the dollar. We therefore stick to our constructive euro forecast for the second-half of 2010.

With the breach of 1.20, the calls for parity in the euro over 2010 have increased sharply. Indeed, investors are at record levels of bearishness on the euro according to various positioning metrics such as IMM positions and sentiment measures such as the skew for bearish euro options (see chart). Market participants are struggling to find any scenario where the euro could stabilize, whether it be more aggressive action by the ECB (“printing money” would weaken the euro), strong European growth data (fiscal austerity would derail it) or a stabilisation in Spanish banking concerns (who’s next?). Such a one-sided view should give one pause. It bears some resemblance to previous sharp market moves, such as dollar weakness last year, which many saw as the end of the dollar as a reserve currency, or asset market declines during the Lehman’s crisis, which many saw as the beginning of a depression.

Record Bearishness on Euro



Source: Deutsche Bank, Bloomberg