

Will the "least ugly" currency experience a significant overshoot?

Everyone is piling into the euro. One of my often repeated hypotheses, during the euro's base building phase, was that it could only appreciate shortly after transformation from a virtual to an actual currency. The reason was based on supply and demand, rather than economic prospects. Prior to the use of euro notes and coins on 1st January 2002, everyone was up to their eyeballs in US dollars. Among individuals, especially East Europeans, there was a massive offloading of mark, franc, lira, etc, notes during 2001, because central banks had announced that these would cease to be legal tender in early 2002. People who did not wish to open euro-denominated bank accounts, swapped their European currency notes mainly for dollars, plus a small amount of Swiss francs and sterling. Among central banks, 77 percent of the world's currency reserves were held in US dollars at yearend 2001. There was no other highly liquid, viable alternative; the US was the only superpower and its economy had been on a roll in the late 1990s. Following a dip to just under \$0.86 in early 2002, the euro started to recover and has seldom looked back. In markets, nothing appears more desirable to the crowd - from black economy savers to central bankers - than an appreciating asset. Paradoxically, the euro is now universally popular as the "least ugly" currency, just as talk of a European and especially a German economic crisis is growing.

Will the euro overshoot my target? Targets are arbitrary, of course, and my guess for the last two years is that the euro would reach \$1.10 to \$1.15, with the possibility of a temporary overshoot. In recent months, I have regarded an overshoot as increasingly likely, although I do not expect it to occur this side of a US-led move for regime change in Iraq. This military move should lead to temporary profit taking in the euro and short covering in the dollar. Whatever the individual political views, markets like strong leaders and strong economies. Euroland remains a basket-case relative to the US, despite the latter's ballooning current account deficit. A weaker dollar helps the US economy and compounds Europe's problems. So why should the euro eventually move above \$1.15, following a reaction shortly after Saddam Hussein is overthrown? In a word - supply. Two years ago, I did not know that Alan Greenspan would sanction the creation of hundreds of billions of dollars, mainly through credit creation, in excess of what could be justified by GDP growth. He is doing so in an effort to avoid Japanese and German-style deflationary stagnation, fund growing deficits, and a war against terrorism requiring record military spending.

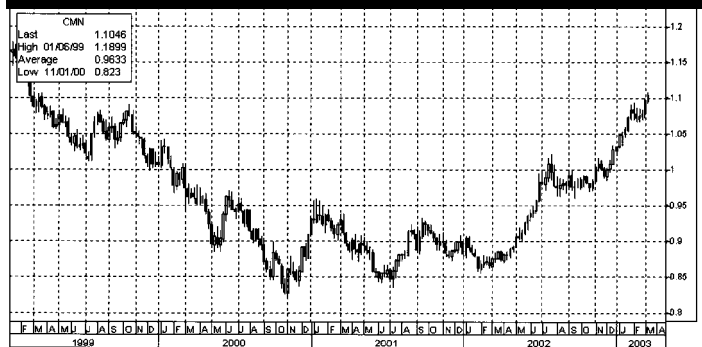
How to play it? For euro/dollar, I would use a trailing stop of approximately 2 cents; Baby Steps lighten on further strength over the next few weeks, and tighten the stop in the event of acceleration. I would consider closing all leveraged euro longs shortly after any war commences. Remember, the crowd is heavily long euros, evidenced by target extrapolations to \$1.30 and above, while people who forecast no recovery for the single

currency two years ago confidently talk of it rising for another two years. Some forex dealers may be tempted to reverse euro/dollar positions, given a technical signal, but I generally prefer not to trade against the primary trend. I'm more interested in shorting the yen, since a Gulf war is likely to coincide with Masaru Hayami's retirement from the BoJ. There is unlikely to be any monetary/political obstacle to a weaker yen with Toshihiko Fukui running the BoJ from 20th March. I currently hold sterling/yen and may increase a small dollar/yen position, looking for a bear squeeze.

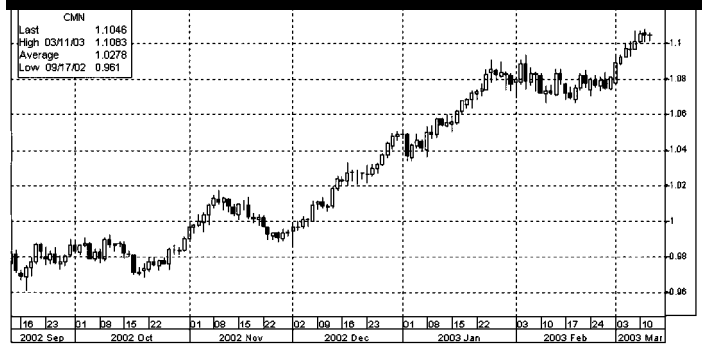
Best regards - David Fuller

Charts by Bloomberg

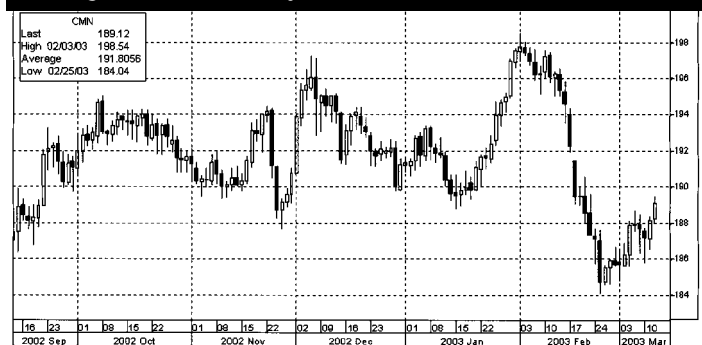
Euro/Dollar: \$1.1046 (Weekly)



Euro/Dollar: \$1.1046 (Daily)



Sterling/Yen: ¥189.12 (Daily)



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