Credit risk shifts to governments

The cohesiveness of the EU will soon be questioned, as individual government deficits will be burdened with increased costs of bailouts for member countries, writes **Sachin Patki**.

February was a busy month for all kinds of traders, as the financial markets experienced turmoil. There are a whole range of issues to work through in currencies. Given the dappled outlook for most economies in 2010, where we expect economies to gingerly foxtrot through periods of sun and shade, currencies are expected to move around a lot as views change per the latest economic or equity earnings release.

The year began with the dollar looking very defensive, the economic situation looking a little bleak and unemployment numbers coasting to double digits. The constant rise of the euro and the commodity currencies has kept the US dollar in a corrective phase. With the interest rate environment not expected to change much for most of 2010, the US dollar has carried a negative interest rate spread compared to its European counterparts.

Statements by Federal Reserve chairman Ben Bernanke indicated that the Fed would look at raising the discount rate as the first step towards tightening money supply. During the crisis in 2008-2009, the Fed pumped as much as US$1 trillion into the economy to ensure that money supply continued to grow and that the economy did not stall. This money supply is now slowly going to be taken out in a graded process towards reliance on market-driven forces for capital. The rising yields on government T-bills and bonds during auctions and the increase in spread differentials on corporate bonds versus US Treasuries indicate a rising market pricing-in of higher costs of lending to corporations in an uncertain economic environment.

All of these factors do not support a sharp reversal in fortunes for the US dollar. However, in the financial markets, all it requires for views to change is a single piece of news.

The news that Greece had a high risk of potential default shook up the markets, with the EU suddenly being put on the spot regarding how far it was willing to defend the member economies. The riots and reactions to potential austerity measures to bring the budget deficit and government debt back to acceptable levels by the population in Greece were seen as a sign that all was not well in the EU. Other economies from 'Club Med' are expected to have similar problems. The cohesiveness of the EU will be questioned, as individual government deficits will be burdened with increased costs of bailouts for these countries.

The euro seemed to be gaining favour with overseas central banks in the first half of 2009 and increasingly looked to be a currency of choice in which to hold reserves. The reversal of this trend at the end of 2009 indicated that the US dollar continues to rule as the currency of preference for most central banks.

The euro has broken down below a crucial 1.3850 level and the consistent presence below this indicates that it may test the 1.3100 level in the breadth of the move. Reversal may be limited to 1.4130 with some selling interest ahead at 1.3850 and 1.3975. A break of 1.3100 would indicate that it will have a sharp dive further to 1.2200.

Although the UK economy is not faring any better, the crisis has not impacted it as much, with the sterling still sitting outside of the common currency. The economic releases show a very middle-of-the-road recovery, with the potential to tip back into a low or no-growth phase post withdrawal of liquidity in the markets. We do expect a domino effect from the Greece situation to impact the UK economy, as the government will have to take its share of the burden of any rescue package. The currency looks to correct lower towards 1.5300, and a potential break of 1.5010 would open up the range

for 1.4850 and 1.4645. A clear close above 1.5900 on a weekly closing basis would indicate a possible short term reversal towards 1.6225, 1.6430 and 1.6750.

The sterling/euro shows some potential to test 1.1770 and on a break give us 1.1850 and 1.2010. On the downside, there is a potential for 1.1210 and 1.1080.

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Views expressed are the author's and not necessarily those of Mashreq. Data and comments are as of February 11, 2010.