Presents

EUR/USD Deadlock: EU Crisis / FOMC Update

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Introduction

EUR/USD, the world's most popular and most liquid pair, is stuck in a narrow range, after the Greek crisis has been put on the back. What will take it out of range? This is a special report from Forex Crunch covering the main forces moving the pair: the EU debt crisis and the US economy towards the FOMC decision.

Note: The original plan was to publish a more comprehensive report for April, covering a wide variety of currencies. Unfortunately this didn't come about, so the first monthly report is planned for May 2012. I'd love to hear your comments at yohay@forexcrunch.com.

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EU Debt Crisis

The crisis has moved to the larger countries, which are "too big to fail": Spain and Italy. Nevertheless, Greece isn't "saved" but rather on the backburner. Things will get more "exciting" in Greece during May, when the country holds general elections.

Portugal and Ireland aren't likely to erupt soon, but their troubles are certainly of concern. On the other side, fears about Germany seem to have faded away for now. France is facing the first round of the presidential elections, which will likely be a warm-up for the second round in May.

Spain – Toxic Combination of Trouble

Change in Bonds Fate

Europe's fourth largest economy had a strong start to the year. The Long Term Refinancing Operation by the ECB encouraged buying Spanish bonds, and Spain certainly seized the opportunity and satisfied nearly half the year's funding needs in less than four months.

How does it work? The ECB lends cheap money to European banks against collateral. It isn't too picky about collateral and it actually encourages banks to buy sovereign bonds. These bonds carry a yield higher than the price banks the ECB, therefore creating an arbitrage. The first operation was in December and the second one in February 29th. That special date created €530 billion euros in the system.

But since then, there is less demand for Spanish bonds, and yields have gone up. The relatively new Spanish government also added to the country's troubles. On one hand, it has suggested quite a few reforms, especially in the two-tiered labor market, and also decided on budget cuts.

On the other hand, it defied Brussels in the deficit target for 2012. The EU wanted 4.4%, and Spain's PM suggested 5.8%. They compromised on 5.3% + tighter EU surveillance, but the markets lost a lot of trust in the process.

Pain in Spain

Spain's issues run deep and wide.

- **High unemployment rate**: Nearly 24% of Spaniards are unemployed. Even if this number is dismissed by some unaccounted for workers (or Economia Negra), this is still in inconceivable number. It partially results from the collapse of the construction sector.
- **No bottom in housing**: Home prices continue falling in Spain and no bottom is within reach. The stock of homes is estimated at around 5 years, and there are a lot of "white elephant" projects. Investment isn't attractive in these conditions.
- **Banking issues**: The consolidation of the Spanish banking system is moving slowly and banks have a lot of construction related debt that is still in the shadows. A recent merger made Caixa Bank the largest bank in Spain, and this poses risk as a "too big to fail" bank, while still leaving a lot of business in the shadows. Without cleaning the banks, the
- **Regional Tensions**: Spain's decentralized political system means that significant parts of government expenditure are managed by the 17 regional communities and are running deficits. Two large regions are in the limelight. Northeastern Catalonia is a relatively rich region with a significant cultural difference and also a high deficit. Who is to blame for the deficit? The debate cannot be detached from ethnic tensions, making any decision making problematic. Andalusia in the south is Spain's largest region and a struggling one. It is currently controlled by the opposition PSOE party, also making every decision politically charged.
- **Contracting Economy**: Thanks to strong tourism, Spain managed to post some modest growth for a limited period of time. Spain's economy turned negative when winter came. A contraction of 1.5% to 2% is on the cards for 2011. More austerity means even deeper contraction as seen in Greece.

Spain has a toxic combination of Portugal's economic weakness together with Ireland's real estate / banking issues.

Prospects for Spain

Austerity can please the markets for a short period of time, and help reduce the debt recycling costs. The debt factor in the debt to GDP equation falls. However, when it causes a lower output, also the GDP factor falls and the ratio rises once again.

On one hand, the government has an absolute majority and still has a strong mandate from November's elections. It also showed that it can say No to Brussels, at least partially.

On the other hand, the serious problems that Spain has are huge. It will probably get worse before it gets better.

ECB Help?

Spain may eventually get some help from the ECB, but not via a third LTRO. The ECB still has the SMP program it already used in the past for Spain. Mario Draghi might use this scheme in order to prevent very high yields, but isn't likely to use it to send yields back to 4%.

The ECB actually has an interest to see higher yields: this puts pressure on the governments to act for a reform. Some say that without such pressure, Spain will not act.

Will Spain ask for a bailout? Not in the near future. Given the speedy funding it made at the beginning of the year, it can still muddle along and pay higher prices in the primary market before crying for help.

Will Spanish problems weigh on the euro? Certainly. They already do, and it will likely get more serious. Spain has so much to sort out, that it will likely stay in the news and hurt the euro for a long time. Spain definitely needs a weaker euro for its exports and for attracting tourists, paradoxically, Spain's troubling headlines indirectly help it.

In the near future, Spain's issues alone aren't likely to send the euro below the range. However, a break down can happen together with other issues, led by Spain.

Italy – Getting by with PR instead of Reform

Europe’s third largest economy has some advantages over Spain, but if bazookas and firewalls or even a Spanish departure could leave the euro-zone intact, troubles in Italy could deal a deadly blow to the euro-zone.

Italy has a much lower ratio of private debt in comparison with its GDP. The unemployment rate is high, but at sane 9.3%. Italian 10 year bond yields managed to break below Spain’s yields, after quite some time of things being the other way around.

Monti’s Partial Success

Nevertheless, the market is expecting Italy to perform its own labor reforms, and they aren’t moving too fast, to say the least. Italy’s technocratic PM, Mario Monti, doesn’t have too much political backing in Italy. Even if he manages to pass reforms that will calm the markets, these can be easily reversed when he steps down in 2013.

2013 sounds far, but the temporary notion of his term has strong ground in Italy and his political power is limited.

Monti, formerly with Goldman Sachs, is certainly good at public relations. He sounds very determined in his speeches, and his bashing of Spain seems to be well heard in the markets.

This will keep Italy afloat in the short term. Italy will hold a bond auction on April 26th, and while it will likely pay a high price, full cover is expected. A failed auction will be worrying and will show that the PR effects are fading out.

It isn’t only about yields and market perception: Italian banks are seeing funds leaving them, and the economy is contracting (something that Italy wasn’t so keen to share). Yet again, its troubles aren’t as bad as Spain’s, but the bad economic reality cannot hide behind Spain for a long time.

German Strength

At least for now, Germany continues to stand out in Europe. Its economy took a small break from strength, but this was short lived. The highly regarded ZEW and IFO indicators are moving higher, and purchasing managers' indices are relatively strong.

Germany is also seeing some signs of stronger inflation: this is seen in the Consumer Price Index and Producer Price Index, as well as home prices which have a very late blooming.

These higher prices in Germany are preventing looser economic policy from the ECB. Lower rates would certainly help peripheral countries stimulate their economies, but the heavyweight Bundesbank's anti-inflationary stance is still dominant within the European Central Bank.

Higher rates may be supportive for the strength of the euro, but counterproductive in the longer run.

French First Round

Europe's second largest economy is facing the first round of presidential elections on April 22nd. Incumbent Nicolas Sarkozy and the main opposition leader Françios Hollande are expected to emerge as the candidates for the second round, held on May 6th.

Hollande has already stated his opposition to the fiscal compact negotiated by Sarkozy and Merkel, and he remains in the leading position to become the next president. His election might add to uncertainty and may hurt the euro.

Yet anything can happen between the two leading candidates until May 6th, and a win of Hollande over Sarkozy in the first round will likely be shrugged off by the markets. A win of Sarkozy will be surprising, but doesn't mean anything until the second round, and will likely be received in the same manner.

Sarkozy is quite unpopular in France, and there's a slim chance that he will come in only third, behind extreme right wing Marine Le Pen. In this case, Hollande will be considered the next president already after the first round, as many moderate

Sarkozy supporters will likely vote for Hollande. In such a case, the euro might drop.

US Economy

On the other side of the Atlantic, things were looking quite good for quite a while. Some worrying signs have emerged and the picture is more complex. How will this impact the FOMC meeting on April 25th?

The Good

- **Growth continues**: The US economy is still growing nicely, contrary to Europe. The initial GDP figure for Q1 will be released on Friday, April 27th, and is expected to show an annual growth rate of 2.6%, not typical for a recovery, but good enough for now.
- **No Deflation Danger**: Prices in the US are on the rise. The Consumer Price Index is at 2.7% and for many Americans it feels even higher, especially in fuel and food prices. The Federal Reserve doesn't look at this, but rather at Core CPI (excluding food and fuel). Also here, 2.3% is above the target of 2%. Such price movements show that the economy is moving.
- **More Building**: Recent building permits figures show a consistent rise in building. At first, this was "blamed" on the warm winter, but now it seems more serious, and gives the notion that housing found a bottom.
- **Active Consumers**: Retail sales are on the rise and consumer confidence (seen in various indicators) remains OK. The US economy is driven by private consumption, and higher expectations mean more activity, even if the pockets aren't that full.

The Bad

- **Unemployment**: After a few strong months, Non-Farm Payrolls disappointed with a weak rise of 120K. Looking deeper into the report shows 5 reasons to dismiss it as temporary. But, there's a good reason why this bullet appears here: jobless claims broke out of a very steady range for quite some time, proving to skeptics what Bernanke stated: that the underlying situation of employment is worse. Bernanke noted the employment to population ration, and others note the low participation rate as one of the economy's main problems.

- **Stalling Industrial Production**: The ISM Manufacturing PMI, Philly Fed Index and other industrial indicators remain positive, on the growth side of numbers. These indicators, which are forward looking, are more closely watched than the actual output, which stalled. According to Lakshman Achuthan of the ECRI, this is a sign that a recession is coming. A recession doesn't seem close, but where is the industrial growth?
- **Home Prices Still Low**: The US housing sector underwent some deleveraging. There's no doubt. But has it reached a bottom? Uncertainty remains very high. According to sales of existing homes, where most of the activity happens, this sector is still wallowing in the mire.

The FOMC

Ben Bernanke look at all this data and much more. The upcoming decision is more significant than the previous one, as it consists of members' forecasts as well as a press conference by Ben Bernanke. This will supply lots of volatility for the markets.

QE3 in June?

No QE3 Now: Some market participants are awaiting for a third round of QE for a very long time. The current economic weakness, even with more worries from the labor market, is not enough for more QE.

Adding more dollars to the markets can raise oil prices, like QE2 did. This will certainly be counterproductive to the recovery, which is fragile anyway. Deflation was one of the leading arguments for QE2, and doesn't exist now, to say the least.

Another reason to expect no QE3 is the recent survey of Primary Dealers that expect QE3 only in June, when the next meeting is planned.

Will Bernanke use the press conference to provide such a hint? A wise question by a reporter can trigger an answer that might be interpreted as such a hint. Nevertheless, caution is needed, as this may be misinterpreted.

War or Words

Bernanke's dovish comments in recent months aren't necessarily a hint for QE3 but also come to contradict what hawkish members are saying.

Since January, the central bank has a conditional pledge to keep rates low until late 2014. Late 2014 is two and a half years away. The purpose of this pledge is to keep long term interest rates low, to encourage lending and investing.

With recent strength, some members have explicitly said that rates may rise before late 2014. 2013 or even late 2012 have been discussed. This undermines Bernanke's authority and may undermine the low yields the Fed wants.

So, Bernanke's softness and his message that everything is on the agenda, should not necessarily be interpreted as a hint towards QE.

So what will the Fed do?

The FOMC isn't likely to introduce any policy change in the upcoming meeting. This means no QE3, and no change in the pledge.

The Fed is likely to recognize the economic weakness in the statement, and add more caution. Economic predictions might be marginally lowered.

A bigger surprise might come with the extension of the "Operation Twist" which ends in June, but there's a higher chance that such a possible move will come only in June. An extension of the twist will likely be bullish for the dollar, as it lowers the chance for QE3.

So, Range Trading or Breakout?

In the near future, it will likely take a big blow to send the pair out of the 1.30 to 1.34 range. Here are some things that can trigger it, but the chances are low.

- Explicit talk of QE3: A break higher
- Superb US GDP: A break lower.
- A re-activation of the SMP by the ECB on a massive scale – a break higher.
- Spain asking for bailout: a break lower.

A breakout can also happen with a combination of small events, discussed above. All in all, this frustrating range will likely continue. Beware of false breaks, as seen recently. Any breakout should be examined very cautiously.

The month of May features is more risky, especially regarding European events: elections in Greece and France, the ongoing Spanish debt crisis and more. In the US, the nature of the slowdown will become clearer: temporary or not. Stay tuned for the monthly outlook.

In the longer run, I remain bearish on the pair. European leaders haven't really dealt with the debt crisis. The temporary measures buy time, and this time isn't used for reforms or growth. Time passes by for the sake of passing it by.

The US isn't growing fast, but it's doing better. With some slowdown in China, the US becomes more important for the whole world.

So, a move lower by the pair is expected, but not in the short term.

EUR/USD Technical – Explosion Coming?

On a technical level, the narrowing channel signals a breakout. Will the technical forces trigger a breakout even when fundamentals are stable?

[Click here to view the image on the web](#)

Narrowing Channel

As you can see on the graph, the trading range of the pair is narrowing down. Both lines began in February, with uptrend support being more significant than downtrend resistance. The support line has also been challenged more recently.

Lines

1.3550 capped the pair in November and December and marked the beginning of the plunge. 1.3486 was a distinctive double top in February 2012 and is a strong cap.

It's closely followed by minor resistance at 1.3437. The pair struggled there when it traded higher. 1.34 is a round number and the limit seen in March, before the pair ground down to an even narrower level.

Quite close by, 1.33 was tough resistance 4-5 times, with two attempts very recently. It remains key resistance. 1.3212 held the pair from falling and switched to resistance later on. It proved itself as resistance once again in April 2012. This was the bottom border of tight range trading in February.

1.3165 is a minor line that provided some support in December 2011 and worked as resistance in April 2012. It is a bit weaker now. 1.3110 is another minor line that capped the pair in January and later in April 2012.

1.3050 worked as support in April 2012 and also in March, and is the last frontier before 1.30. The round number of 1.30 is psychologically important and is now stronger than earlier. It managed to keep the pair from falling.

The 1.2945 line is stronger once again and still provides support. 1.2873 is the previous 2011 low set in January, and it returns to support once again. This is a very strong line separating ranges.

1.2760 is a pivotal line in the middle of a recent range. It provided support early in the year. 1.2660 was a double bottom during January and the move below this line is not confirmed yet. 1.2623 is the current 2012 low, but only has a minor role now.

For more on the euro, see:

- **EUR/USD Weekly Outlook**.
- **A recent Elliott Wave Analysis of EUR/USD** pointing to the lower limit of the pair

Additional Notes for Forex Traders

Here are some additional notes for forex trading during this quarter.

Choppiness

Range trading has led to more choppy trading and false breaks in this popular pair. When a break comes, this choppiness might fade away a bit, but it's important to be very cautious. Here's how to deal with false breaks.

Choosing a More Predictable Pair

Some pairs follow the rules of technical analysis in a better way, while others are quite unpredictable. This depends a lot on your trading system and on your style and these patterns change all the time. Nevertheless, here is an updated list of the **5 Most Predictable Currency Pairs – Q2 2012**.

Resources

General Articles

- **5 Points on When to Go Pro** – Successful at forex trading and considering of doing it full time? There are a few steps on the way.
- **How to Choose a Forex Broker in 2011** – There are quite a few tools you can use before making this important decision.
- **How About Investing in Forex?** – Foreign exchange doesn't necessarily have to involve active trading, but can be
- **Risk Factor Explained** – A deeper explanation about why the dollar falls on good figures and vice versa and under what conditions this will end.
- **Trading in Range or Catching Breakouts?** – What is your style? And what to look out for.

Recommended Sites:

- **TradingNrg** – For all you need to know about gold, oil and other commodities.
- **BO Crunch** – All you need to know about trading binary options.
- **ForexStreet.Net** – A great forex social site where you can interact with others.
- **Forex Live** – For the fastest updates on the web.

That's it! As I've mentioned at the beginning, I welcome feedback, comments, suggestions, complaints and anything you wish to tell me about this report. Please send any feedback to yohay@forexcrunch.com.

Happy forex trading!