

Euro Shorts May Start Feeling the Burn

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Pair	Bias	Objective/Comments	Key Resistance	Key Support
EUR/USD	↓	Higher on short-covering, lack of sellers after downgrades	1.2818	1.2475
USD/JPY	↓	Quasi-pegged near 77 level by threat of BOJ intervention	77.77	76.33
GBP/USD	↓	1.5342 is the line-in-sand and major multi-year pivot	1.5415	1.5342
AUD/USD	↓	In holding pattern between 1.04 and 1.0130	1.0400	1.0130
USD/CAD	↑	Also in a range between 1.0310 and 1.0130	1.0319	1.0077
USD/CHF	↑	USD strength giving likelihood for upside to 0.9665	0.9525	0.9370

Headlines

- S&P takes ratings actions on 16 Euro-Zone nations, downgrades EFSF
- Chinese GDP comes in at 8.9%, higher than 8.7% estimate
- Moody's chief says Greece is insolvent and will default
- Euro sentiment at risk of snapping back from bearish extremes

Summary

Usually when the Euro rallies on bad news, the move gets attributed to positive data from elsewhere, like China. Why China decides to have its most important economic releases coincide with European news is another story, though.

But we believe there's a much more sensible reason for the 185 pip rally in Euro from the lows put in during Friday's downgrades of European sovereign debt. There is also a potentially painful scenario developing for shorts should the Euro break through additional resistance levels.

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Key Economic Events

- 04:30 – UK CPI, **4.2%** vs. 4.2% cons.
- 05:00 – EZ CPI, **2.7%** vs. 2.8% cons.
- 05:00 – GE ZEW Survey, **-21.6%** vs. -49.4% cons.
- 08:30 – US Empire Manuf., **13.48** vs. 11
- 09:00 – CA BoC Rate Decision, **1%** vs. 1% cons.
- 23:30 – JP Industrial Prod., -2.6% prior

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Record Bearish Sentiment

A deceptively simple way of explaining why the EUR/USD has managed to pop after extremely bad news from sovereign debt downgrades, is that there were simply not enough sellers left over after so many weeks of rumors of downgrades going on. By Friday's news, COT positioning on Euro futures contracts reached a new record of 155,195 net short positions from large speculators. This is the single best illustration of the extreme bearish sentiment that **led up to** the eventual downgrades. But with the idea finally playing out, there is a risk that the extreme number of shorts will be squeezed on even a modest move through resistance, triggering many stop-losses.



Figure 1: EUR/USD (top) and COT positioning (bottom). Orange line is the net positioning of large speculators, which is at their highest short position ever. Red vertical lines show when large specs turn net short (bearish) and green vertical lines net long (bullish)

Source: FX Club Research and Bloomberg

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Risk Reversals

The next signal we will turn our attention to is the 3-month risk reversals in EUR/USD. Risk reversals are an option strategy designed to hedge against an upside or downside move. A higher number in 25-delta risk reversals means hedging for a move higher in Euro, and a lower number means hedging for a downside move.

The most recent move up in RRs is placing us at a massive 64% move from their lows in November. The move has only accelerated through December as players have gradually hedged against a snap back in Euro during volatile holiday trading, and it is even higher from Friday's level of -1.7475.

The bottom line here is **seller beware**. Fundamentally it is still a dire situation for the European economy and the US Dollar is by far the world's preferred safe haven currency, giving it more long-term upside.

But just as we saw the bailout deal in the Fall of 2011 and the Greek haircut culminate in a 400 pip rally only to be retraced 2 days later, the market could be looking to **cause the maximum possible pain for current short positions** before continuing in a steady trend lower towards lows around 1.20.



Figure 2: 3-month 25-delta risk reversals for EUR/USD (red line). Sharp rebounds usually signal an impending short squeeze in EUR/USD.

Source: Bloomberg and FX Club Research

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Technicals



Technically speaking, Euro has essentially achieved reaching a multi-year support area at 1.26, giving it room to bounce towards 1.29 or so before new sellers are able to enter the market.

Figure 3: Daily EUR/USD chart

Source: FX Club Research and Bloomberg

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