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The Euro Turns Radioactive

Longer-Term Investors and Companies, Not Just Hedge Funds, Shun the Currency

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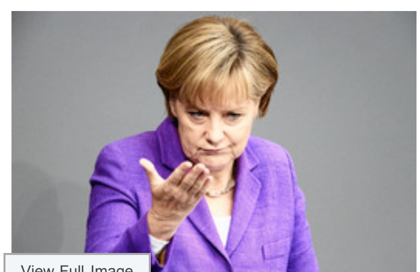
By MARK GONGLOFF, ALEX FRANGOS And NEIL SHAH

Some of the world's largest money managers and central banks have become increasingly skeptical of the euro, presenting a threat to the common currency's prospects.

So far during the euro's months-long descent, attention has been focused on hedge-fund selling of European assets but central banks and large managers have a much-larger influence on foreign-exchange markets. Even if they don't dump euro assets, a mere pause in their buying could weigh heavily on the currency.

The euro on Wednesday rose to $1.2385, bouncing from $1.2143, its lowest level against the dollar in four years hit during the day, and from $1.2210 late Tuesday in New York. It was only the second gain in seven days against the dollar for Europe's shared currency, which has slumped nearly 15% against the dollar this year.



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Germany Chancellor Angela Merkel calls for a major overhaul of Europe's fiscal rules Wednesday during a speech in Berlin.

South Korea's central bank, which has about $270 billion in foreign-currency reserves, among the biggest in the world, said this month that the euro zone's sovereign debt problems make the euro, used by 16 nations, less attractive as a reserve currency. Iran's central bank chief this week said that country may rethink its reserves, which the Central Intelligence Agency estimates around $81 billion. And Russia, with $400 billion in foreign-currency reserves, said it shifted its mix of reserves away from the euro last year.

Mutual-fund data show that in recent weeks, European and U.S. investors have shifted out of euro-zone equity funds. Asia's largest bond fund, Kokusai Asset Management's Global Sovereign Fund with $40 billion under management, lowered its euro allocation from 34.4% in March to 29.6% on May 10, according to a company manager. And portfolio managers with huge money pools, such as Allianz SE's Pacific Investment Management Co., or Pimco, and Baring Asset Management, expressed caution on the euro in interviews with The Wall Street Journal.

To be sure, not all money managers are selling euros, and some see the currency's weakness as a buying opportunity. An advisor to China's central bank, the biggest player in currency

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as a buying opportunity. An adviser to China's central bank, the biggest player in currency markets with more than $2 trillion in reserves, said this week it planned to keep diversifying its vast dollar holdings, which has in the past involved buying euros.

China, Russia and large emerging-market holders of currency reserves have tried in recent years to shift their mix of holdings in favor of euros, expressing worries about the fiscal health of the U.S. While China's may still diversify, many banks began paring their euro exposure late last year, and the wariness has lately become more apparent.

Recent euro weakness is a sign that longer-term investors and companies, not just hedge funds, are heading toward the exits. The shift is causing worries that central banks could be next. WSJ's Mark Gongloff discusses.

"The program of diversifying out of dollars has come to a screeching halt," said Collin Crownover, managing director and global head of currency management for State Street Global Advisors. "If the downward progression of the euro continues, then you see outright selling of euro-zone assets, and it snowballs and gets worse."

Money flowed out of Europe at an annualized pace of $50 billion in the first two months of 2010, according to Jens Nordvig, managing director of currency research at Nomura Securities International. That pace has likely increased in recent months, contributing to the euro's recent decline.

That outflow is likely due almost entirely to large investors, partly because hedge funds likely have reached the upper limit of their ability or desire to place bets against the euro, suggests Mr. Nordvig.

"Somebody new is selling now," he said.

And unlike speculative investors, long-term investors likely won't quickly change their recent behavior even if the euro enjoys a respite.

"It's too early in the evolution of this particular crisis to assume all's well and investors should jump back into places that have burned them in the past few weeks," said Scott Mather, head of global portfolio management at Pimco, the world's largest bond-fund manager.

Many "real money" investors that might be expected to buy the euro on dips in value are staying on the sidelines given Europe's discouraging economic outlook and persistent grumblings in Germany over the cost of bailing out crisis-racked Greece.

"It's making a few people think, 'What am I getting into?' " said Colin Harte, director of fixed-interest and currencies at the London office of Baring, which has more than $47 billion under management. "What if you buy the euro and the Germans vote with their feet and leave" the currency union?

While Mr. Harte would normally buy the euro at its current rate, he says he can't really predict where the euro will go from here. His forecast ranges from $1.10 to $1.34 by year-end.

Central banks, which held a combined total of around $7.5 trillion in reserves at the end of last year, form the backbone of the currency markets. Their slow and steady shifts out of the dollars they generally receive from trade or commodities exports, and into other currencies, play a big role in determining exchange rates.

Reserve managers wouldn't need to sell euros at this point to hit the currency hard. Instead, they would merely need to slow down the pace of euro purchases, and that risk is needling market watchers now.

Central banks "are not as active as they had been," said Adam Reynolds, co-head of currencies and fixed income at Societe Generale in Hong Kong. His firm, like others, processes currency trades on behalf of central banks, sovereign-wealth funds and private investors.

—Katie Martin, Andrew Monahan and Min Zeng contributed to this article.

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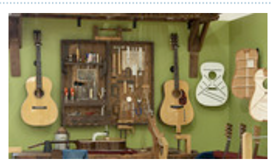

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