FOREX-Dollar weakens broadly as U.S. data weigh

Tue Feb 28, 2006 9:39 PM GMT

(Recasts, updates prices, adds comments and quotes, changes byline)

By Jamie McGeever

NEW YORK, Feb 28 (Reuters) - The dollar weakened across the board on Tuesday after a measure of growth in U.S. Midwest economic activity came in lower than expected, fueling expectations that the Federal Reserve may not have much more room to raise interest rates to curb inflation pressures.

Investors will now look to other economic indicators to see if the slower-than-expected growth in manufacturing in and around Chicago was a blip or part of a more general slowdown.

"The dollar rally of recent weeks may have stalled today," said Axel Merk, manager of the Merk Hard Currency Fund in Palo Alto, California.

"What's important here is that maybe a slowing U.S. economy directly translates into a lower dollar. And we are likely to see more of that as evidence grows that the housing market is in trouble -- much of the job growth last year was, very broadly speaking, housing-related," Merk said.

The National Association of Purchasing Management-Chicago reported that its index of Midwest business activity fell to 54.9 in February from 58.5 in January, falling short of analysts' expectations for an unchanged reading.

A reading above 50 denotes expansion.

Other data on Tuesday showed that sales of existing U.S. homes fell in January by 2.8 percent to a 6.56 million annual rate, and the inventory of unsold homes was 5.3 months' worth -- the highest since August 1998.

Late on Tuesday, the euro was up 0.6 percent from late Monday at $1.1920 <EUR=>, and the dollar was down 0.4 percent against the yen at 115.75 yen <JPY=>.

The dollar was down 0.8 percent against the Swiss franc at 1.3120 francs <CHF=> and sterling was up almost 1 percent at $1.7540 <GBP=>.

The greenback was down 0.4 percent against the Canadian dollar at C$1.1358 <CAD=>, near its lowest since December 1991.

VOLS FALL

The euro remains well supported down around $1.1800-50, with traders citing persistent talk of central banks and reserve managers buying down at these levels.

Widespread expectations that the European Central Bank will raise rates by a quarter percentage point to 2.5 percent on Thursday are also supporting the currency.

Markets are pricing in an increase in short-term U.S. rates to 4.75 percent next month but investors expect the Fed to raise rates only one more time this year, to 5.00 percent by June.

The Chicago PMI data didn't do anything to boost these expectations, nor did a slight dip in U.S. consumer confidence in February as measured by The Conference Board.

The Commerce Department revised upward U.S. fourth-quarter gross domestic product growth estimates to 1.6 percent from an original reading of 1.1 percent.

The GDP report showed that inflation as measured by the core personal consumption expenditures -- which excludes food and energy prices, and is the Fed's favored measure -- fell to 2.1 percent from 2.2 percent originally reported.

Much of the market's immediate focus on rates is on Japan and when the Bank of Japan will change its policy of flooding the banking system with cash.

Some analysts say it could be as early as next week, while others say by the end of April although few expect the BoJ to actually start lifting interest rates any time soon.

Still, the prospect of Japan's ultra-loose monetary policy coming to an end has lifted the yen recently.

However, Japanese finance minister Sadakazu Tanigaki on Tuesday said Japan was still in mild deflation.

Despite some intraday choppiness, broad ranges remain intact. This has helped drive down implied volatility, which measures the anticipated trading range of a currency over a given period of time, to multi-year lows in some cases.

"One has to wonder if the financial markets are underestimating the risk in the financial markets with both currency and bond vols near historic lows," Thomas Rogers, senior currency analyst at IFR Forex Watch in New York, wrote in a research note.